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## AN ADIRONDACK VIEW

April 15, 1955. What a due-day! Here's a list:

- U. S. Individual Income Tax Returns for 1954
- N. Y. Individual Income Tax Returns for 1954
- U. S. Partnership Income Tax Returns for 1954
- N. Y. Partnership Income Tax Returns for 1954
- U. S. Fiduciary Income Tax Returns for 1954
- N. Y. Fiduciary Income Tax Returns for 1954
- U. S. Corporation Income Tax Returns for the fiscal year ended January 31st. And you add to fit your office.

In April, also, the U. S. Withholding and FICA tax returns; and the N. Y. Unemployment tax returns. What a month! with a few annual reports as a side line.

What we don't understand is why this 15th day of April wasn't the opening day for baseball—the announcement of the results of the Salk tests—and the Montgomery-Ward annual meeting.

There was still a three foot pile of snow at our back door—and ice in the boat house. Somebody's all mixed up.

LEONARD HOUGHTON, C.P.A.  
"Adirondack Chapter"

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## Book Reviews

### How to Save Estate and Gift Taxes

By J. K. Lasser Tax Institute and Ralph Wallace. AMERICAN RESEARCH COUNCIL, New York, N. Y., 1955. Pages: x + 310; \$5.95.

In non-technical language, primarily addressed to the layman, this book is essentially two elements: first, a basic primer on Federal estate and gift taxes; second, a compilation of estate planning procedures designed to minimize these taxes.

In justification of its title, the book features "25 tax-saving ideas." The scope of these suggestions may be indicated by the following sampling from the table of contents:

Make A Gift, Though in Contemplation of Death

Assign Your Life Insurance

Make a Will

What to Do about Jointly Owned Real Estate under the 1954 Tax Law

How a Family Corporation Can Make Estate Planning Easy by Issuing Preferred Stock.

The authors properly advise the reader to secure qualified professional advice in connection with property transfers and dispositions motivated by tax-saving considerations.

The book also contains the following material: Federal estate and gift tax rates; Tables I and II for values of life estates and remainders; Section 81.10(i) of Regulations 105 pertaining to the valuation of annuities, life estates, remainders and reversions; computation of estate tax when the tax is interdependent with a deduction; and Revenue Ruling 54-77, IRB 1954-9, valuation of closely held stock.

Estate and gift tax counselors should know the tax-savings procedures described in "How to Save Estate and Gift Taxes." However, practitioners should also be conscious of the human problems in estate planning. Thus, tax considerations must complement the essential dispositive requirements of the client.

This reviewer admires the clear presentation by the authors of complex subjects in simple, direct language.

FRED LINDEN

New York, N. Y.

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## Book Reviews

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### Municipal and Governmental Accounting (Third Edition)

By Irving Tenner. PRENTICE-HALL, INC., New York, N. Y., 1955. Pages: xvii + 569; \$8.65.

This book is a revision of the second edition published in 1947, and which carried the names of Carl H. Chatters and Irving Tenner as authors. It discusses and describes the accounting principles, standards, and procedures applicable to state and local governments. In view of the similarity between the principles of governmental accounting and those used in accounting for hospitals, colleges and universities, its scope has been enlarged to include chapters dealing briefly with accounting for such institutions.

As in the second edition, the chapters relating to governmental accounting are consistent with the principles formulated by the National Committee on Governmental Accounting and the Municipal Finance Officers Association, and give effect to the many changes in principles, account classifications, and terminology which have been developed in the interim. The contents of two publications of the National Committee on Governmental Accounting, namely, "Municipal Accounting and Auditing" published in 1951, and "A Standard Classification of Municipal Accounts" published in 1953, form the basis for much of the material in Mr. Tenner's present volume. Mr. Tenner, acting as consultant to the National Committee on Governmental Accounting, prepared the original drafts of these two publications and, after they had been reviewed by members of the National Committee and various advisory committees, the final drafts were then revised by him in the light of comments and suggestions made by the committee members.

The arrangement of this edition closely follows that of the second edition. The subject matter is dealt with in 21 chapters, of which, 2 chapters covering 36 pages relate to accounting for institutions. The contents are well illustrated with 129 figures including 85 specimen financial statements and schedules, 29 general accounting forms, 13 forms and schedules for use in the preparation of the budget, a chart of balance sheet accounts, and a specimen auditor's certificate. In addition, there are 4 tables relating to sinking fund requirements, amortization of bond premiums and discounts, and depreciation. The 4 appendices and the index take up another 189 pages, of which 155 are devoted to 161 questions and 148 problems dealing with the subject matter. The appendices also include a summary of accounting principles and procedures recommended by the National Committee on Governmental

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## Book Reviews

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Accounting, governmental accounting terminology as adapted from the Committee's book entitled "Municipal Accounting and Auditing", and a bibliography. The subject matter assumes the use of the accrual basis as applied to governmental accounting throughout the book unless other bases are specifically mentioned.

There are three bases of accounting which may be used in recording the revenues and expenditures of governmental agencies, namely, the cash basis, the accrual basis, and the modified cash basis. Under the cash basis, revenues are not taken into account until collected and expenditures are not recorded until the cash is paid out. The accrual basis provides for taking revenues into account as soon as earned regardless of when collected, and for recording expenditures at the time the liabilities are incurred without regard to when the actual payments are made. The modified cash basis is similar to the cash basis except that expenditures are recorded in the same manner as under the accrual basis.

There can be no justification for using the cash basis. Under this method a government could be virtually bankrupt but the accounts would not reveal this condition. In the opinion of this reviewer, the term "accrual basis" as applied to governmental accounting is completely misleading. To begin with, practitioners in this field know that it is not possible to take such substantial items as sales, income, and utility taxes into account at the time they are earned. No information is available as to the amounts due until tax returns and payments are received which, of course, is some time after the revenue has been earned. Furthermore, there are various items of prepaid expenses and accrued liabilities such as unexpired insurance and accrued interest on bonds and notes which are not set up in the accounts. In view of these facts, how can we say that the accounts are kept on the accrual basis?

The National Committee in its "Municipal Accounting and Auditing" states that "in actual municipal practice, however, the complete accrual basis is not encountered often." It further states "However, even if a governmental unit does not accrue all of its revenues and expenditures, it is usually considered to be on an accrual basis providing it accrues the more important ones." This it refers to as the "slightly modified accrual basis." The Committee recommends "that to the extent applicable the accrual basis (that is, the complete accrual basis or the slightly modified accrual basis) of accounting should be followed." It justifies this recommendation by stating "such a basis

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## Book Reviews

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is desirable because it makes possible a more accurate comparison of revenues and expenditures than any other basis", and that "such a comparison is possible under the accrual basis because under it revenues earned during the year are compared with expenditures incurred during the same period."

As to revenues, the basis recommended by the National Committee produces a figure which includes the total of certain revenues earned during the current period, whether collected or uncollected, and for other revenues (many of which are substantial in amount) the total amount collected which may have been earned during the current and/or the prior fiscal year. This reviewer has his doubts as to the value of comparing the revenue total thus obtained with expenditures for the period. In the absence of the profit motive in government operation, except for government operated utilities and other self-supporting enterprises, the matching of income and expense as required in commercial accounting is not vital and is only of passing interest.

The National Committee criticizes the modified cash basis, under which revenues are taken into income only at the time of collection, as being "inconsistent". However, the treatment of revenues under this basis as compared with that under the accrual basis is the acme of consistency, and results in a figure which has a definite meaning. Balance sheets prepared under the accrual basis produce a surplus which is not available for expenditure because it includes certain uncollected revenues. Under the modified accrual basis the surplus balance, in general, consists of the difference between the cash balance and the amount of payables, including unliquidated encumbrances. On page 55 of the book under review, the balance sheet of the general fund at the close of the fiscal year, determined under the accrual basis, shows an unappropriated surplus of \$8,800.00 whereas under the modified cash basis it would show a deficit of \$69,700.00, or a difference of \$78,500.00 consisting of the net amount of receivables. In the light of the foregoing discussion, it would seem that the deficit of \$69,700.00 can be more readily understood and explained than the surplus of \$8,800.00.

In preferring the use of the modified cash basis over the accrual basis, it should be understood that this reviewer advocates the establishment of controls over receivables offset, however, by appropriate contra accounts. These accounts would be adjusted periodically for the amount of collections made. The desirability of providing for estimated losses from uncollectibles, espe-

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## Book Reviews

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cially with regard to real estate taxes and special assessments, is subject to question. As to these items, the law usually provides ways and means of enforcing collection by sale of liens and/or eventual foreclosure. These steps should obviate the necessity of charging off anything except in isolated cases where the amount realized from the sale of tax sale certificates or foreclosed properties is less than the amount of the tax liens plus interest, penalties and costs.

Municipal and Governmental Accounting contains clear and concise discussions of the principles employed and illustrations of the application in actual practice. Its chapters include detailed explanations covering: the methods by which the budget is prepared and controlled through the accounting system; the purpose, meaning and classes of funds; the methods of classifying revenues and expenditures and the procedures in recording them in the accounts; the accounting and reporting for each type of fund; the accounting for cash; the procedures in levying and accounting for general property taxes; the methods of accounting for fixed assets; the accounting for liabilities including the bonded indebtedness; and the methods used in determining pertinent operating costs. In addition, a chapter is devoted to auditing standards and procedures, the audit report, and the annual and monthly financial reports. The chapters on institutional accounting illustrate the application of fund accounting to account-keeping for hospitals, colleges and universities. The accounting forms and specimen financial statements interspersed in the text are well designed, and many of the accounting forms can be readily adapted to machine operation. The questions and problems are arranged in the chapters to which they relate.

Mr. Tenner's volume provides an excellent textbook for students in accountancy and public administration, and will prove helpful to teachers, practitioners, and public officials for reference purposes.

New York, N. Y.

ERNEST W. CARB

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## Book Reviews

(Continued from page 264)

**Proceedings of the New York University Thirteenth Annual Institute on Federal Taxation (November 3-12, 1954)**

Edited by Henry Sellin, MATTHEW BENDER & COMPANY, INC., Albany 1, N. Y., 1955. Pages: xiv + 1326; \$25.00.

This is the current volume of the reported proceedings of this noteworthy annual Institute on Federal Taxation, begun (in the words of Paul A. McGhee) "some fourteen years ago as an ideal and a dream in the rigorous mind and the generous heart of Mr. J. K. Lasser", who died unexpectedly during the summer of 1954. It opens with a beautiful tribute to the late "Yoc" Lasser by his good friend, Dean McGhee, head of New York University's Division of General Education, which has sponsored this annual Institute series ever since its inception. The program of the 1954 Institute attempted to deal with the problems engendered by the new Internal Revenue Code of 1954, and to give "high-level advice on how to live with the first entirely new tax law of our time."

Seventy-four papers written by eminent tax practitioners, and covering the following fourteen fields, comprise this work: The Tax Problems of Individuals; Estate Planning and Associated Problems; Office Procedures and Machines; Compensation Problems: Pensions and Profit Sharing; Compensation Problems: Deferred Compensation, Stock Options; Corporate Problems: Distributions; Liquidations; Corporate Problems; Miscellaneous Corporate Problems; Partnerships; Techniques in the Trial of a Fraud Case; Accounting Changes, Depreciation; Practice and Procedure; and Capital Gains and Basis. A Table of Statutory References, a Table of Treasury Regulations References, and an Index complete the work.

The current volume of the Proceedings thus becomes another invaluable link in the chain of practical and authoritative tax papers presented in this distinguished annual series.

**1954-1955 Cumulative Supplement to Tax Manual for Divorce and Separation**

By Charles B. Bayly, Jr. NEWKIRK ASSOCIATES, INC., Albany, N. Y., 1955. Pages: 38; \$1.90.

The basic text is brought up to date by reference to the Internal Revenue Act of 1954 and to cases decided since the original publication. In addition to the text revisions, there are helpful tables of cases and cross reference between the 1939 and 1954 Codes.

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EMANUEL SAXE, *Managing Editor*

*The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.*

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No. 5

## The President's Page

### Valedictory

THIS is my swan song. The Walrus sets the pattern for my last fling—talk of shoes and ships and sealing wax, of cabbages and kings. A few glib forecasts will be made to boot.

*Tax Practice:* I have a feeling that out of the present vast stretches of no-man's land will emerge a new sovereignty or profession in tax practice. The citizenry will come largely from the ranks of lawyers and accountants, but nevertheless be separate and apart from their progenitors. Schools of taxation are already beginning to emerge in colleges and universities. Degrees in taxation are now being issued.

The evolutionary process is likely to go through several stages. An increased number of accountants will become lawyers, too. Lawyers will increasingly gain their bearings in accounting. Then will come the inevitable schism whereby the tax specialists of both groups will coalesce and chart their own seas as "taxperts", or some other label that will recognize and immunize their technical trade brand.

*Accounting Practice:* If tax practice flowers into its own hegemony there will be a void to be filled in accounting practice. Actually, and regardless of the status of tax practice, accounting is already beginning to extend its reaches. "Management Advisory Services" increasingly beckons to the public accountant. Recently, both the Institute and the Society set up committees to consider this area. Many accounting firms already have departments geared to serve in this field. I predict that management ad-

visory work will become standard equipment in accounting practice.

There's another pasture looking for cultivation—cost accounting. In the past, accounting practice has merely nibbled at it. In the future I think it will become a real good chunk of activity. Industry faces increased intensity and rigors of competition. The need for knowledge and control of costs will be acute. Thus far the public accountant has really fought shy of cost work. I don't believe he will be able to fend off the siren very much longer.

*"Two-Class" Legislation:* Developments in respect to tax practice are already giving impetus to the need for some thoroughgoing introspection by accounting as to the structure of the profession. It is said that today we are half regulated, half free. That Lincolnian reference is to the fact that in some states the profession is regulated; in some states it is not. In some states anyone can hang out a shingle as an "accountant"; in some states a license is required. In some states there are CPA's and PA's. In some states the PA's are a dying class; in some they are permanent.

This variety is hardly the spice of accounting life. It was a long hard road to unify the CPA examination throughout the country. The road is longer and harder to unify the legal structure of the profession. But come it will, as come it must. Too much of the public's—and the profession's—interest is at stake to permit anyone to practice free of licensure and control.

The long, long-range is for an accountant and CPA to be synonymous, because practice will be permitted only to CPA's. The interim approach will be through legislation that makes a dying class of non-CPA's.

*CPA Requirements:* The education and experience requirements for becoming a CPA today are almost as diverse as the number of states, territories, and districts issuing the CPA certificate. I look to the day when all jurisdictions will operate on the same wave-length. The coordinating and unifying force in this respect will undoubtedly generate from the findings of the Commission on Standards of Education and Experience for CPA's. The year 1956 should bring the Commission's report upon the scene. It can serve as the basis for dealing with the various legislatures.

Now that we have uniform CPA examinations, I wonder whether we are not called upon to take inventory, and determine whether the uniform fits. When less than 25% of the candidates pass the examination, serious question is raised whether there is something wrong with the candidate or the examination. In the old days, we thought the high mortality was caused by the fact that many of the candidates were unprepared for the examination. In New York, we stepped up the entrance requirements as to previous education and experience. Nevertheless, the percentage of passing persists on the low side. Question: Is it the examination or is it still the candidate?

These inquiries have some very practical significance. We are spending all sorts of money, time, and energy to attract qualified young men to the profession. Don't we defeat our endeavor by a bottle-neck that prevents many of these young men from getting into the profession, or discourages them

from entertaining any interest in the profession at the outset.

Furthermore, unhappiness abounds when a young man has spent years at college followed by years in gaining experience, and then he repeatedly fails to get by the admission gate. This unhappiness has a way of exerting legislative pressures that can, in turn, produce unwholesome results. Some newspaper editorials have already appeared accusing us of running a monopolistic closed shop.

Wouldn't it be a good thing to give this whole area a thoroughgoing review in an atmosphere of far-sighted thinking?

*Civic and Political Relations:* I do hope that it won't be long before the profession starts rolling on the civic and political front. Today, our most serious vacuum is in this area.

We will not be doing right by our nation—or ourselves—until CPA's abound in Congress and in state and local legislatures. We will still be suffering from pernicious political anemia until accountants, and accountants alone, occupy accounting positions in government and political parties—positions like comptrollers, budget directors, treasurers, and auditors.

These things won't come about by wishful thinking. Politics is eminently practical. We must be ready to apply the leg work, the head work, and the financial sacrifice that go with public service. I believe that the profession will prove itself equal to the challenge.

\* \* \* \* \*

This is the eleventh, and, as I mentioned at the outset, my last President's Page. I am grateful for the opportunity it afforded me. It has been a wonderful work-out and a lot of fun.

J. S. SEIDMAN  
President



# Some Problems of the Local Practitioner

By ROBERT E. WITSCHHEY, C.P.A.

*This is a frank discussion of some basic problems facing local accounting practitioners—the determination of a proper professional fee; the recruitment, training and compensation of staff; and the peculiar and varied accounting requirements of small business units, including “write-up” services.*

THE little town on the Ohio River where I was born has produced four certified public accountants. Two of us started with large firms and two with very small ones. That is not particularly important or unusual. What is significant is that a CPA is now engaged full-time in the practice of his profession in that little town. He is earning a respectable living. More and more this is happening all over the

country. One-man or small-staff offices are growing in numbers. My own practice is in a town of about 65,000.

Many problems have attended the rapid growth of local accounting practices. Fortunately, our profession is aware of, and sympathetic toward those problems so that by cooperative effort we are solving many of them. There are still those which give us serious concern.

Why should there be problems that are peculiar to the CPA practicing alone? Our special problems arise largely out of the nature of, and type of service which we offer to our clients. From my experience I would like to offer two generalizations:

- (1) The general purpose of the large firm of CPAs is to independently verify the reports of management—in short the audit.
- (2) The general purpose of the individual or small local CPA firm is to provide a wide variety of high level accounting services to small business units at a fee which the client can afford.

The basic factors out of which most of the problems in the small office arise are inherent in this second generalization. Let us look at the component parts of it.

- (a) Wide variety of high-level accounting services.
- (b) Small business units.
- (c) Fee which the client can afford.

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A past president of the West Virginia Society of CPAs, he is also a member of the National Association of Cost Accountants, and the Kanawha Valley Accountants Association, and has been general chairman of the Middle Atlantic States Accounting Conference.

For several years before opening his own public accounting practice in Charleston, West Virginia, Mr. Witschhey was an agent with the Bureau of Internal Revenue. During the war, he served in the United States Navy on special assignments in connection with revised cost accounting for shipyards.

This address was delivered by Mr. Witschhey at a regular meeting of the Society held on December 13, 1954, at the Hotel Roosevelt in New York City.

### Conflict of Problems

A discussion of these components, as they relate to a small accounting office immediately raises three fundamental problems that frequently pull against each other. These considerations are discussed in detail in an article by Marquis Eaton.<sup>1</sup>

The first is, that the accountant must maintain a financially healthy office, i.e., he must receive fees commensurate with his professional skill. That rate of compensation must be high enough to attract to the profession the type of mind necessary to perform high quality accounting engagements. Too many accountants make the serious mistake of accepting a low hourly return, and then try to build this rate into a respectable annual average by spending extra hours at their desks. It is not flattering to the profession to create the impression that its product is of so little value that a fair living can be obtained only by working far longer hours than is generally considered enough to earn an acceptable living in other professions.

A second consideration, and here the conflict begins, is that the local CPA deals almost exclusively with a business unit that must place a definite dollar limit on what it can pay for professional assistance. That dollar limit is probably higher than many CPAs think, but it does exist and must not be exceeded. For example, an audit cannot be done below a certain minimum cost because minimum standards of performance must be observed. Many small businesses cannot afford the minimum fee that must be obtained from such an engagement.

The third consideration is that the services performed must have a value commensurate with the cost to the client. Since this matter of fees seems to be one of our especially difficult ones, I shall consider it first. In view of the wide variety of services per-

formed by the local CPA, the problem of fixing a rate of compensation for all types of engagements is difficult. It is probably fair to assume that most local CPAs believe that there should be a different basis for computing fees for audits, tax work, write-ups, monthly statement preparation, and so on. Some indication that the assumption is correct is found in a study of fees in the Southern States conference area.<sup>2</sup> Of those replying to a questionnaire of the Arkansas Society, 93% preferred a per diem basis for determining fees for audits. However, 74% believed that fees for tax work should be based on the type of job. The questionnaire did not cover monthly statements and write ups.

### Fees

On the question of specific per diem rates charged there was a wide range of answers in the Arkansas report. Per diem rates for partners or individual practitioners ranged from \$35.00 per day to \$150.00 per day, with slightly over half of this group reporting per diem rates of from \$50.00 to \$100.00 per day. The rate for seniors ranged from \$25.00 to \$75.00 per day. The largest group, (29%), reported a range of \$35.00 to \$50.00, while 24% reported a per diem charge of \$25.00 to \$30.00 per day. For juniors the per diem rates ranged from \$15.00 to \$50.00, with the largest group (32%) reporting a range of from \$25.00 to \$30.00.

There was a much wider range of charges for tax work than for audits—from \$2.50 to \$20.00 per hour—and generally rates for tax work were higher. The largest group (29%) preferred a \$10.00 per hour charge.

Admittedly, the number of replies to the Arkansas questionnaire is too small to be considered an adequate sample. However, a more widespread survey made by the AIA Advisory

<sup>1</sup> Opportunities for Serving Business in Small Communities, in *How to Improve Accounting and Tax Service to American Business*, American Institute of Accountants, 1950.

<sup>2</sup> News Letter, Arkansas Society of Certified Public Accountants, September, 1953.

Committee of Local Practitioners seems to follow rather closely the same pattern. One disturbing implication of these reports is that some of those reporting could not make a fair annual income if they worked 2,000 productive hours per year. From this and other information gained by discussing fees with substantial groups of local practitioners, it seems clear that many are not charging fees commensurate with services performed. Part of the difficulty may lie in our concern with productive hours. Because of the rapidly changing nature of our profession a substantial amount of our time must be devoted to keeping abreast of current changes both in accounting and tax practice. All such hours should properly be recouped in our fees.

Much can be found in our professional publications concerning fees. However, most of the articles discuss the variety of factors to be considered in arriving at a fee. We have been just a little timid in talking to one another about our own fee scales. Members of other professions are less coy in establishing rates within their profession. I'll tell you about mine.

I have a small staff who have been with me for from one to six years. On every engagement we keep time for each accountant employed. That time is extended at \$5.00, \$6.00, \$7.00 or \$9.00 per hour, depending on the experience of the accountants. My own time is extended at \$12.00 per hour. When the engagement is complete these charges are totaled. To this sum is added all travel and out-of-pocket expense. For many of our engagements this final sum is the fee which is billed with the simple description, *For Professional Services*.

There are occasions when the billing may be different from the hourly accumulation. Every engagement is scrutinized before billing to determine that the fee is commensurate with the

services performed. Tax work charges are usually revised upwards on the theory that this kind of work should carry the bulk of time devoted to reading and study. In addition, the value of our skill is most dramatically emphasized in cases involving tax disputes. Frequently, in such a dispute the saving to the client may be out of all proportion to the time involved. In those cases I just do the best I can in trying to determine what a proper fee should be. As an example, shortly after the war the treasurer of a coal company came to a local CPA. His company was a rather small one but during the war years had made good profits. Of course much of it was paid out in taxes. Their problem was a rather simple one involving one of our local taxes and was readily answered. However, in glancing over the federal income tax returns for prior years, the accountant noticed that the deduction for depletion was based on a very low cost. The Treasurer had done a pretty good job of preparing the returns, only no one had ever told him about percentage depletion. It took about four days to prepare the claims which resulted in refunds of about \$27,000. Obviously, knowledge rather than time was the factor in arriving at the billing.

On the other hand, the amount of time devoted to an engagement may be out of proportion to a fee that the client can afford. This situation is often found in a small business which has not previously engaged a public accountant and whose records have been poorly maintained, if at all. Frequently, our accumulated charge is revised downward in such a case, particularly if it appears that the client will become a continuing one. I have told some of you, perhaps, that the first thing I have to do is teach some of my new clients to save their records. Next time I call I find they have saved them in a barrel. Then I have to teach them to save the barrel.

All of this discussion of fees adds up to the fact that the fee determination is a much more difficult task in the very small accounting office than in the large one. The large CPA firm can fix hourly or per diem rates by grades of staff men. These firms deal to a considerable extent with clients who are familiar with, and who recognize the value of the CPA's service. On our engagements, which are usually one-man jobs, the accountant must do all the things to be done whether it be of junior or principal level. Often our clients make little distinction between us and any bookkeeper, and it is difficult to obtain a professional fee if you are not set apart as a professional man.

### **Write-up Work**

A substantial part of the income of many small offices is obtained from fixed monthly charges for write-up work and I want to talk briefly about this kind of service. I know that in the past there have been those who frowned on so called bookkeeping or write-up service being performed by a CPA. I have never concurred in such beliefs because I have felt, and continue so to feel, that such engagements offer both a tremendous opportunity and challenge to the individual practitioner, as well as some professional hazards. I offer some reasons for that belief.

1. Anything to be done that requires a thorough knowledge of accounts can best be performed by a CPA.
2. In no other way can the CPA obtain such an intimate and thoroughgoing knowledge of his client's affairs.
3. Monthly write-up work, done by a CPA, can be, and usually is, something much more important than just bookkeeping.
4. A more even spread of income is obtained.
5. This kind of service tends to level off the peak periods.
6. The accountant is afforded an opportunity to keep close watch on the tax implications of transactions.
7. Most important of all is the sound background of information provided to the CPA from which he can advise his client on many aspects of operating his business. This management counseling is one of the most important services that the individual practitioner can provide to his clients.

During the next twelve months a large number of small businesses will fail. 97% of all those failures can be attributed to management weakness. Managerial incompetence or inexperience shows up in many ways some of which are:

1. Inadequate records.
2. Inaccurate information as to costs.
3. Lack of inventory controls.
4. Failure to budget expenditures.
5. Excessive operating costs.
6. Little or no internal control or check.
7. Little or no tax planning.
8. Faulty purchasing practices.
9. Faulty sales policies.
10. Insufficient capital.
11. Lack of effective credit policies.
12. Excessive investment in plant and equipment.

There are many others. The point is that the CPA who deals regularly with his clients' records can and does keep watch over potentially weak areas in the management function. So. I



reiterate that these periodic write-up engagements are just as important as anything you can do. There is one point that should be especially emphasized—do not ever call any engagement a "routine write-up engagement". It is an accounting engagement of high order and deserves the best of your ability. By this same standard the fee received should not be based on a misconception that the engagement is routine and therefore billed at low rates. Your monthly fee should be in keeping with your high professional skill.

Before leaving the subject I would like to add a few words of caution.

1. Some accountants become so overloaded with this type of engagement that they have no time for other, more remunerative opportunities that may come along.
2. Too great an involvement with this kind of service may give the accountant the name of public bookkeeper.
3. Frequently, accountants forget that this type of service should be used to develop further accounting needs of their clients, and to provide a basis for training new employees.

#### **Dealing with Small Business Units**

Now let us consider the problems arising from the fact that we, in small offices, deal almost exclusively with small business units. Many small businessmen keep records only because there is external pressure on them to do so. There is the need for information for a tax return or the need for financial statements to hand to bankers or creditors. Many small businessmen have not yet learned to use financial statements as a management tool. The individual practitioner has to do an educational job in these cases to train the management of a small business to use this very valuable tool in the conduct of his business.

I have heard representatives of national firms say that they operated their special services departments dealing with small businesses at little or no profit. The individual practitioner must earn his living dealing almost exclusively with those small businesses. As I have said before, there is a definite limit to the amount which such a business can pay for accounting services, just as there is a limit to the amount it can pay for any other legitimate expense item. When we get into such an engagement we find that there are all sorts of things that we could do which would be beneficial for the client. However, we must very carefully analyse the requirements of the client to determine what are the most essential and important things that need being done and then we must do these things in the order of their importance and within the fee limitations.

#### **Wide Variety of Services**

The last component part of the function of the small practitioner is the wide variety of accounting services which he must provide, and this too poses serious problems. It means that he must keep up with current trends in accounting—at least to some extent in budgeting, sales policies, credit policies, purchasing policies, and many things. Obviously, the reading and study time of the local practitioner must of necessity be spread rather thinly. Add to this the fact that an individual practitioner does not have a business—he has only an independence. This means that no matter how much reading he may have to do, he must still devote a substantial part of each day to productive work.

#### **Staff Compensation**

Somewhat more specific information exists in connection with compensation than with fees. A recent survey by Frank S. Endicott, Director of Place-

## Some Problems of the Local Practitioner

ment, Northwestern University<sup>3</sup> notes that the trend of starting salaries for accountants ranged from \$215.00 per month in 1948 to \$297.00 in 1953. However, many of the accountants were in private industry.

Staff compensation cannot be discussed in terms of salary only, since compensation plans range all the way from the simple payment of a fixed salary, to the payment of a fixed salary with bonuses based on various production or profit schedules, numerous fringe benefits involving health, life and accident insurance, pensions, vacations, and so on. It is not possible to discuss all phases of compensation in this paper. One of the most important and detailed discussions was written by A. Stanley Harmon,<sup>4</sup> who points out that payment to a staff member depends primarily on the nature and value of services he renders and, to a lesser extent on classification, training, experience, and length of service.

Mr. Harmon adds two factors which cannot be ignored by local practitioners. One is that compensation is sometimes based on what a firm must pay, the other that it is sometimes what the firm can afford to pay. The compensation that a firm must pay is the minimum competitive rate in the locality for a given classification. If the firm will not pay that, it cannot secure personnel. If it cannot pay that, it is not established on a sound economic basis.

The same chapter in the *CPA Handbook* contains a tabulation of minimum-maximum salary ranges, including base pay plus periodic bonuses, as of December, 1951. It is apparent from the table that minimum rates of small firms are lower than those of

large firms but their maximum rates tend to be about equal.

Before leaving the subject of compensation I should like to make a couple of observations. One is that the quality of work produced by any local practitioner depends on the training and skill of his employees. The second is that to obtain this type of employee costs money. But there is no question of not being able to afford high-caliber employees—the local office can afford no less than the best if it hopes to compete successfully.

### Time Records

Time and expense record-keeping is one of the more important office procedures, since it serves as a basis for building the firm's income, though I quickly add that I never seem quite happy with the system I have. Systems of time recording range from the simple diary used in a small office to the more elaborate methods necessary in larger firms; and, if my experience is typical, then as staff size begins to grow it becomes necessary to keep refining and elaborating the system of time and expense record-keeping.

A rather simple but effective method of time recording has been discussed recently in two articles in *The Journal of Accountancy*. The first was written by John Stoy,<sup>5</sup> and the more recent one by Marion R. Reich.<sup>6</sup> Briefly, the method consists of the use of padded tickets. One ticket per day per client is prepared by each staff man. The ticket shows the client's name, description of work, time, and expense. Tickets are made for unproductive time as well. The tickets are sorted from time to time and placed in en-

<sup>3</sup> "Trends in the Employment of College and University Graduates in Business and Industry, 1953", *Journal of College Placement*, March, 1953.

<sup>4</sup> "Staff Compensation & Utilization", *CPA Handbook*, Chapter 10, American Institute of Accountants, 1952.

<sup>5</sup> "Time—Record System For Smaller Accounting Offices," *The Journal of Accountancy*, April, 1951.

<sup>6</sup> "Accounting For Time Charges in a Public Accounting Practice", *The Journal of Accountancy*, March, 1954.

velopes, one envelope for each client. Both writers report that these envelopes are printed so that they can be used as a client's ledger sheet.

### Personnel

The strength of the profession and the quality of the services it provides are dependent upon the competence, the character, and the professional attitude of those who are engaged in it. We are confronted with two difficult problems in this respect — (1), how can we assure a continuous and ample flow of competent young people into the profession, and (2), how can we best utilize these people on our staffs to provide our clients with the highest quality accounting service?

The problem of getting a sufficient number of able young people into the profession has been made one of the major projects of the American Institute of Accountants' committee on accounting personnel, headed by Samuel J. Broad.

After the acquisition of accounting personnel comes the problem of more effective utilization of staff men. Each year accounting firms have been confronted with mid-year and end-of-the-year peaks. In between are those periods of severe recession from the normal tempo. During rush periods our regular personnel must work long hours under pressures and strains that might endanger the quality of work. In addition, it is frequently necessary to employ temporary personnel who are usually unacquainted with the policies and practices of the firms employing them, and are probably neither as well qualified nor as experienced as the permanent personnel.

An equally disturbing extreme is the slack season, when it may be necessary to release a trained and skilled staff member.

During the preparation of the *CPA Handbook* the American Institute made a survey of peak-load conditions. It was reported that almost 70 per cent of the small and medium-sized

firms find the semi-annual concentrations of business constituting a major problem for them. Four specific solutions offered by many firms were: (1) induce clients to adopt their natural business year; (2) increase interim work; (3) make quarterly or semi-annual audits; and (4) increase monthly examinations.

### Staff Training

Perhaps the most difficult of problems in the local accounting office is that of providing a sound training program for young staff men. In the past, a substantial part of the work in many small offices was that of supervisory record-keeping, for which a competent bookkeeper would suffice. But local practitioners have realized that competent bookkeeping techniques applied to their clients' affairs provide only a minor part of the service clients need. The problems of a small business are as complex, in many respects, as those of large enterprises. I think it is a fair statement to say that the small client looks to his CPA for solutions to more varied problems than does a large business, many of whose problems are answered internally.

This is not to belittle the importance of supervisory record-keeping in a small office. Even if we did not wish to have any part of it, we could not escape a certain amount of such work. It is a necessary part of our service to many small clients. But if the local practitioner hopes to grow in stature, he must decide to keep pace with his profession and maintain its standards, so that he will be able to perform competently those things which will best serve his clients. It is obvious that such growth will depend on just how well staff men are trained. The lack of sufficient personnel can be overcome by a judicious selection of clients, but there is no alternate method of overcoming the handicap of a poorly trained staff.

This problem of training staff men is particularly acute in small offices for

several reasons. We have not yet even approached a plan of training that would compare with the in-service training programs of the national CPA firms. Do not have any misconceptions about it—such training programs provide a young man with a great deal of knowledge that is immediately usable in a small office. I have had experience both with those trained in large and in small firms. I cannot help but wish that each new man I employ in the future could have at least two years of training with a large firm.

The problem of training in a small office is made more difficult because our engagements are, for the most part, "one-man" engagements. The work load would ideally be divided by degrees of skill and experience, i.e., junior work for juniors, more advanced work for semi-seniors, and so on up the ladder, with the staff man moving upward in an orderly fashion as his judgment feeds and grows on experience. In a small office the division of work is more often by clients rather than by grades of work. The result is that, while we are likely to train the staff man in the specific problems of specific clients, we fail to provide him with the broad background of experience so vitally necessary if he is to become fully mature. A further result is that a trained staff man may sometimes be doing junior grade work while a junior is idle.

Another difficulty of training men in a small office is that of finding time to do it. For most of us the task of finding just one extra hour in the working day is a major operation for several reasons: (1) Because our clients are usually small, we must carry a larger numerical load of clients per man. This, in itself, multiplies the problems of administration and office procedures. (2) We cannot go in for much specialization in a small office. Every staff member must acquire a sound knowledge of many

things—auditing, cost accounting, income taxes, budgeting and others. This requires that a substantial amount of our time be devoted to reading on many subjects.

The problem of training staff men in small offices is going to be solved. Mr. Broad's committee, which I mentioned earlier, has under consideration a number of projects designed to do just that.

### **Professional Cooperation**

I have only touched on some of the problems that are peculiar to a small CPA practice. There are many others some of which are serious ones with us. One that confronts us in a small office is that we seldom have anyone with equal or more experience with whom to discuss our problems. This handicap has been substantially overcome by many individual practitioners by the simple process of discussing those problems with specialists in large firms. I have had many letters from individual practitioners reciting the very generous help that they had had from large firm members. This real cooperation that now exists between CPAs, and its continuing development, is one of the pleasantest aspects of small office practice.

### **Conclusion**

Fortunately, too, our profession recognizes that our problems exist and over a period of years much has been done about it. Those efforts continue through such organizations as our State Societies and the American Institute of Accountants. When you come right down to it, however, these things I have been talking about are really growing pains and so long as we continue to have growing pains, I think we should not be too concerned. There are other problems, much more significant in nature, which confront the entire profession and the solutions to them will probably be more vital

(Continued on page 289)

# Thoroughbred Racing Association Accounting

By RICHARD M. DONOVAN

*After briefly tracing the history and economic importance of organized thoroughbred racing in New York State, the author outlines the methods of accounting for the income and expenses of Thoroughbred Racing Associations. He then explains pari-mutuel operations at such associations in New York State.*

**I**n my talk tonight it is my intention to outline briefly to you the methods of accounting for income and expenses of Thoroughbred Racing Associations. Since your committee has indicated particular interest in pari-mutuel operations, I shall deal with that at some length.

## Thoroughbred Racing in New York State

Before talking about the accounting controls, I would like to tell you something of the history and economic importance of organized thoroughbred racing in New York State. In this very county in which we meet tonight the first race course was laid out in 1665. Almost three hundred years ago this first course called Newmarket was located in what is now the Village of Hempstead.

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During the past seventeen years he has handled the accounting assignments of several of the Thoroughbred Racing Associations in New York State.

This paper was presented by Mr. Donovan before the Long Island Chapter of the National Association of Cost Accountants, on November 16, 1954.

The more recent history of thoroughbred racing in New York commenced in 1865, when the Saratoga Association was founded. Shortly before the end of the nineteenth century there were two tracks in the New York City area. Aqueduct opened in 1894 at its present site. Belmont was incorporated in 1895, raced for many years in the Bronx and, in 1905, moved to its present site in Nassau County. Just after the turn of the century two other associations came into being—Empire at Yonkers in 1900, and Jamaica at its present site in 1903. The five associations that I have mentioned constitute the principal associations in New York today. Through the years many other associations have formed and disbanded. That, briefly, is the history of thoroughbred racing in New York.

Now, I would like to take about one minute to tell you of the economic importance of the thoroughbred racing industry in New York State. In 1953, this industry paid to New York State and local taxing authorities of this State approximately forty-five million dollars. Of this sum, the State of New York received \$32,525,600. for taxes on pari-mutuel operations, admissions and supervisory and license fees. This tax was collected by the State from five associations which held race meetings during the racing season of 197 days, attended by 4,501,555 persons. The thoroughbred racing industry in New York State in 1953 directly employed about 5,000 persons

whose earnings aggregated \$18,000,000. or an average of \$3,600. per employee. In addition to this number, about 1,100 persons were employed by the catering, parking, program and other concessions serving the industry during the racing season.

### Balance Sheet

The balance sheet of a thoroughbred racing association does not differ greatly from the balance sheets that you are accustomed to seeing for a service type of business. What is unusual about it? Well, for one thing it shows large balances of cash and marketable securities and negligible accounts receivable. Its current ratio is probably about 5 to 1. An association must have adequate cash balances to meet its operating and maintenance expenses during approximately ten months between race meetings, and must provide a bankroll of about one and one-half million dollars for its mutuel department at the beginning of the meeting. Since racing is a cash business, its accounts receivable amount to a few thousand dollars.

The few thousand dollars of accounts receivable represent amounts owed to the association by owners of horses. As a matter of fact, it is rather unusual for horse owners to be indebted to the association because, by custom, the owners deposit substantial sums with the association at the beginning of the meeting to establish credit. These deposits range between one-half and three-quarters of a million dollars. Against this credit, their accounts are charged for all charges incurred by them during the meeting.

Such charges would probably include:

- 1—Entry fee—The fee charged for entering a horse in a stake race.
- 2—Jockey fee—The fee charged by a jockey for riding a horse.
- 3—Claiming—The amount paid by an owner to acquire a horse entered in a claiming race.

- 4—Transfers to other horsemen's accounts.

Purses are credited to horsemen's accounts and are payable 72 hours after the race. At the end of the meeting any balances owing to horsemen are promptly paid to them by the association.

One unusual item on the balance sheet is cash in bank for the redemption of outstanding pari-mutuel tickets and the contra-liability for these tickets. Every year thousands of people go to the tracks, wager on horses through the mutuel machine, win the wagers and then destroy the winning tickets by mistake or simply neglect to collect their winnings. The cash account mentioned represents the cash on deposit in a special account for the purpose of redeeming such outstanding tickets, or "outs" tickets as designated in track terminology. Whatever monies remain in this account by April 1st of the following year are paid to the State of New York. In 1952, this amounted to \$163,000.

### Income Statement

When we look at the income statement of a Thoroughbred Racing Association, we see that the income is derived from three principal sources:

- 1—Pari-mutuel commissions (including breakage): The association's commissions for handling wagers of its patrons.
- 2—Admissions.
- 3—Concessions.

Pari-mutuel commissions account for about 69% of the total income, admissions 27% and concessions and miscellaneous 4%.

Aside from pari-mutuel commissions, which I will talk about later, the chief source of income is from admissions to the track. The two principal types of admissions are the clubhouse and grandstand. The clubhouse admission charge is \$4.95 which includes Federal, State and City admissions taxes of \$1.65. The grand-



stand admission is \$1.95 of which 65 cents is admissions taxes.

The sale of tickets is recorded on machines the same as you find in any movie-theatre box office. As the customer enters the track the stub of his ticket is detached and his entrance is recorded by a turnstile. The control of admissions income is provided therefor by matching up the turnstile count with tickets sold. A further verification is provided by counting the stubs, and a final step reconciles the total tickets sold and unsold with the number of tickets printed.

### Expenses

Expenses are divided generally into two classes:

- 1—Operating expenses.
- 2—Administrative and other expenses.

The operating expenses are those expenses which are incurred in connection with the race meeting conducted by the association. These include:

- 1—Stakes, purses and awards.
- 2—Salaries and wages of all personnel except office and administrative.
- 3—Contracted services, such as:
  - a) Rental of Totalizator
  - b) Admission ticket sellers and security officers
  - c) Photographic services
  - d) Thoroughbred Racing Protective Bureau
  - e) State supervisory services
  - f) Transportation of horses
- 4—Maintenance and repair of track, buildings and equipment.
- 5—Depreciation of buildings and equipment.
- 6—Insurance.
- 7—Other operating expenses.

Some of these terms are probably strange to you, so I will explain them briefly:

*Stakes, purses and awards* represent the prize for winning a race and are paid by the association to the owners of winning horses. Such purses are usually divided among the first four horses, with the largest share to the owner of the horse finishing first.

*Salaries and wages* include those paid to pari-mutuel employees, racing officials, maintenance crew, ushers, ticket takers and other personnel employed by the association solely for conducting the race meeting.

In addition to those employees engaged by the association, the association contracts for various services to enable it to conduct its meeting. Probably, foremost among the services contracted for is the *rental of the Totalizator*. This equipment which is commonly called the "Tote" adds electrically the amount wagered on each horse in a race, together with the total wagered for the race. The "Tote Board" is located in the infield of the race course, visible to all spectators, and flashes the amount wagered in three pools—namely, "Win", "Place" and "Show". I will have more to say about these when I talk about pari-mutuel operations.

*Photographic services* provide the equipment and personnel to photograph the finish of each race.

The *Thoroughbred Racing Protective Bureau* is a national organization employed by the associations to maintain a discipline over all persons connected with the industry to assure the public of honest racing.

*State supervisory services* provide for the supervision of the associations' activities by the New York State Racing Commission.

*Transportation of horses* is a service that provides for transporting a horse between the track where he is stabled to the track where he is to compete in a race. This service is between local tracks only.

The second group of expenses is administrative and other expenses. These

require no further explanation because they include the usual costs of administering a business organization.

### **Pari-Mutuel Wagering**

Pari-mutuel wagering is not new. Years ago bookmaking was practically unknown in this country. Betting on the race tracks was wholly through auction pools and pari-mutuels. In 1871, James E. Kelley opened a winter book on the Belmont Stakes. In 1873, an English bookmaker began making book on New York tracks. He made money and induced others to join him in the new method of betting. Presently, it became so popular that it monopolized speculation on the running turf and auction pools and mutuels were banished to the Trotting tracks. Pari-mutuel wagering in its present form came to New York State in 1940, after the voters in the preceding year had decided to amend the constitution so as to make it legal. Incidentally, New York was the last of the racing states to make this shift from the old book-betting system. A distinguishing feature of pari-mutuel wagering is that it is the public who makes the odds.

The pari-mutuel operations at all New York thoroughbred racing associations are handled by the same well-trained, experienced group of pari-mutuel personnel. Under the supervision of the pari-mutuel manager, this personnel is classified roughly into four groups:

- 1—Sellers—whose title indicates their function, namely selling tickets for pari-mutuel wagering.
- 2—Calculators—who check the recordings on the "Tote Board" during the wagering period, calculate the payments in the winning pools and prove up the entire operation at the end of each race.
- 3—Cashiers—who pay off the holders of winning tickets

upon presentation and surrender of such tickets.

- 4—Money room cashiers—who count all the money taken in by the sellers and balance each seller for each race.

For the convenience of the association's patrons, sellers' windows, similar to any ticket window, are divided into three groupings by pools: "Win", "Place" and "Show".

The "Win" pool is for those patrons who wish to purchase tickets to back a horse to win; the "Place" pool to run second and the "Show" pool to run third. Under each of these classifications are windows indicating the denomination of the ticket that may be purchased there. These denominations are \$2, \$5, \$10, \$50 and \$100. For a patron wishing to back a horse for "Win", "Place" and "Show" there is a combination ticket available.

Wagering is done by purchasing a ticket or tickets representing the horse of the buyer's selection in one of these denominations. Each ticket sold is printed at the moment of sale and registered by machine simultaneously. The seller's machine records the number of tickets sold on each horse in the race. Electrical adding machines in the mutuel department record the amount wagered on each horse in each pool and the total of each pool. At 90 second intervals the amounts accumulated in these machines are flashed on the "Tote Board" in the infield along with the odds on each horse, electrically computed. This process continues during the wagering period for each race, usually thirty minutes, until the official post-time when the machines are locked by electrical control and no further wagers can be made.

In the calculating room, the calculators then record the amount wagered on each horse in each pool. The total of these amounts agrees with the amount recorded on the "Tote Board". The authorized commissions (in 1954,

## Thoroughbred Racing Association Accounting

9% to New York State, 2% to New York City or local township, and 4% to the association) are then deducted to arrive at the net pool or the amount to be returned to the holders of winning tickets. When the winner of the race is announced the calculators compute the amount to be paid on the winning horse to \$1.00. This is done by dividing the amount wagered on the winning horse into the net pool and computing to the nearest multiple of five cents the pay-off per dollar, including profit and wager. The odd pennies not included in the pay-off is the breakage which is divided between the State and association, 60% and 40% respectively. The only exception to the division of commission and breakage occurs when the meeting is held at Saratoga. At this track the commission is 8% to the State, 2% to Saratoga County, and 5% to the association. Breakage at Saratoga is divided equally between the State and the association.

Calculations are also made for the "Place" and "Show" pools but these differ slightly from the calculation for the "Win" pool. When the winner and second horse are announced the calculator for the "Place" pool deducts from the net "Place" pool the total amount wagered on the horses finishing first and second. He then divides the remainder or profit in half. Into one-half of this remainder he divides the amount wagered on the winning horse in the "Place" pool and into the other half divides the amount wagered on the horse that ran second. This determines the profit per dollar to which is added the wager.

Perhaps a simple example will illustrate this calculation better. Assume that there are five horses in the race and horse #4 wins and horse #2 places. The calculation in the "Place" pool follows:

HORSE	WAGER
#1 .....	\$ 5,000.
2 .....	8,000.
3 .....	12,000.
4 .....	6,000.
5 .....	9,000.
Total .....	\$40,000.
Less: Authorized Commissions .....	6,000.
Net Pool .....	\$34,000.
Less: Wagered on:	
Horse #4 .....	\$ 6,000.
Horse #2 .....	8,000.
	14,000.
Remainder or Profit .....	\$20,000.

$\frac{1}{2}$  of \$20,000. = \$10,000.

To calculate return on #4:

Divide \$6,000. (amount wagered on #4) into \$10,000. ....	= \$ 1.65
Add: \$1.00. for each dollar wagered on #4 .....	1.00
Total return to \$1.00 .....	\$ 2.65

To calculate return on #2:

Divide \$8,000. into \$10,000. ....	= \$ 1.25
Add: \$1.00. for each dollar wagered on #2 .....	1.00
Total return to \$1.00 .....	\$ 2.25

A similar calculation is made for the "Show" pool except the profit is divided into three equal parts and the amount determined for each horse as in the "Place" pool.

All calculations are made manually, checked by machine and double-checked.

When the race is declared "official" the official sign is flashed on the "Tote Board" and the cashiers are notified of the amount to be paid on each winning ticket.

I would like you to note that "Win" tickets are redeemable for horses placed First; "Place" tickets are redeemable for horses placed First and Second, and "Show" tickets are redeemable for horses placed First, Second and Third.

The accounting control of the pari-mutuel operation must be very exact. This accounting starts with the sellers immediately upon the automatic closing of the pari-mutuel machines at the official post time for each race. As soon as the machines close, each seller lists the reading of his machine, noting only the number of tickets recorded on his machine for each horse. He then places this tally on top of his receipts, but he is not permitted to count his receipts. Since he does not start with a change fund, all the monies in his possession are receipts and these are then picked up and taken to the money room where they are counted and checked against the tally of tickets sold by each seller. As a double check, a supervisor takes off from each machine the number of tickets sold on each horse.

A summary of tickets sold is prepared from the supervisor's take-off sheet and computations made of the total pools and the total wagered on the winning horses to verify the total recorded on the "Tote Board".

Each race is proved and balanced out in its entirety.

A fund is given to each cashier for the purpose of cashing winning

tickets. After each race each cashier prepares a memorandum of the tickets cashed and turns in this memorandum with the tickets. Tickets are then checked for authenticity and the amount paid. At the close of the day, the cashier turns back the unused funds and his account is balanced up by the money room. The count made by the money room is final with respect to sellers' receipts and cashiers' funds. A summary of pari-mutuel tickets cashed is prepared at the close of the day showing the number and value of winning tickets sold, the tickets paid and the number and value of outstanding or unredeemed mutuel tickets.

The entire pari-mutuel operation for the day is recapitulated in a condensed sales report.

The operation of the pari-mutuel department is closely supervised by the State Tax Commission whose representatives work directly with the pari-mutuel personnel to verify the totals wagered, the pay-off prices and the amounts due the State as a tax on the operation. The City of New York also has a representative present at tracks located in that city to verify the city's share.

The point to be emphasized is that, in racing operation, the internal control system must be set up to operate with "split-second" accuracy. The payments on winning tickets must be made as promptly as possible after the close of the race in order to insure the patron an opportunity to collect his winnings and formulate and place his wagers on the following race. In this respect it is unlike other businesses where the pace can be more leisurely. A person certainly would not want to engage in the functions of the calculating room unless he was extremely facile and accurate with figures.

Accuracy is important because errors which result in overpayments cannot be recouped once the tickets have been redeemed. Frequent errors repre-

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# New York City's New Allocation Formula for the General Business Tax

By PAUL W. COOK, C.P.A.

*This paper discusses the recently released new allocation formula applicable to receipts from interstate commerce on New York City General Business Tax Returns. It is the author's opinion that while the new formula appears to meet the objections to the old formula laid down in Gulf Oil Corp. v. Joseph, it may still be vulnerable to attack in other respects.*

THE Comptroller of the City of New York has recently released the new allocation formula applicable to receipts from interstate commerce on New York City General Business Tax returns due May 15, 1955. This action was made necessary by the decision of the New York Court of Appeals last year in the case of *Gulf Oil Corp. v. Joseph*.<sup>1</sup> While the new formula appears to meet the objections made in that decision to the old formula, it is the purpose of this article to show that in other respects the new formula may be vulnerable to attack.

## The Old Formula

The General Business Tax Regulations promulgated by the Comptroller require (and this requirement has been only slightly changed as a result of the recent controversy) that receipts be classified as follows:<sup>2</sup>

1. *Receipts from sales in foreign commerce*, which are of course constitutionally exempt.

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2. *Nonallocable and nontaxable receipts*, which are receipts "from sales transactions where both the shipping of the goods and the delivery thereof to the purchaser take place entirely outside the territorial limits of the City of New York." Here, of course, jurisdiction to tax is lacking.

3. *Wholly taxable receipts*, which are either:

- a. Receipts from sales by a City vendor where shipment takes place from a City point to a point within the State (whether within the City or not), or

- b. Receipts from sales to a City purchaser by a vendor maintaining a representative in the City where shipment takes place from a point within the State to a point within the City.

4. *Allocable receipts*, which are receipts from interstate commerce, or to put the matter differently, receipts which fall into categories identical to 3(a) and 3(b) above, with the exception that "point outside the State" replaces "point within the State."

Having set up these classifications, the City recognized that it could not base its tax on receipts in Class 1 or Class 2, but it took the position that the tax could be measured by the entire Class 3 receipts, plus a portion of Class 4 receipts. On this theory, then, a formula was necessary for application to Class 4 receipts only.

<sup>1</sup> *Gulf Oil Corp. v. Joseph*, 307 N. Y. 342, 121 NE 2d 360; July 14, 1954.

<sup>2</sup> General Business Tax Regulations, Article 211.

**The old formula:**

$$\begin{aligned}
 & \frac{\text{Property in New York City}}{\text{Property in United States}} \\
 & \frac{\text{Wages and salaries in New York City}}{\text{Wages and salaries in United States}} \\
 & \frac{\text{Wholly taxable receipts plus } \frac{1}{2} \text{ allocable receipts}}{\text{Wholly taxable receipts plus allocable receipts}} \\
 & \frac{\text{Total}}{\text{Allocation percentage}} \\
 & \quad = 33\frac{1}{3}\% \text{ of the Total}
 \end{aligned}$$

**The new formula:**

$$\begin{aligned}
 & \frac{\text{Property in New York City} \times \frac{\text{Allocable receipts}}{\text{Allocable and wholly taxable receipts}}}{\text{Property numerator} + \left( \text{Property outside New York City} \times \frac{\text{Allocable receipts}}{\text{Allocable and nontaxable receipts}} \right)} \\
 & \quad = \frac{\text{Property numerator}}{\text{Property denominator}} = \frac{\text{Property}}{\text{factor}} \\
 & \frac{\text{Wages and salaries in New York City} \times \frac{\text{Allocable receipts}}{\text{Allocable and wholly taxable receipts}}}{\text{Wages numerator} + \left( \text{Wages and salaries outside New York City} \times \frac{\text{Allocable receipts}}{\text{Allocable and nontaxable receipts}} \right)} \\
 & \quad = \frac{\text{Wages numerator}}{\text{Wages denominator}} = \frac{\text{Wages}}{\text{factor}} \\
 & \quad \quad \quad \text{Total} \\
 & \quad \quad \quad \text{Allocation percentage} \\
 & \quad \quad \quad = 50\% \text{ of the Total}
 \end{aligned}$$



## New York City's New Allocation Formula for the General Business Tax

Two factors of the old formula were quite unexceptional. The property factor had average real and tangible personal property within New York City as its numerator, and average real and tangible personal property in the United States as its denominator. The wage factor was wages, salaries and other personal service compensation in New York City over the same in the United States. The operation of these two factors was favorable to the City. If a taxpayer had a City salesroom with one employee, and a factory outside the City but within the State from which deliveries were made to City purchasers, the formula developed very low property and wage factors; the receipts from deliveries in the City, however, were wholly taxable. For a factory or other principal place of business in the City, high property and wage factors were developed for use against receipts from sales throughout the United States. Furthermore, the taxpayer had here no ground of attack, for, by limiting the numerators to property and wages in the City, the taxing authority was completely within its rights if its underlying premise—that it could reach interstate commerce receipts—was correct.

The receipts factor was not so impregnable. Its numerator was the sum of the wholly taxable receipts and one-third of the allocable receipts. The denominator was the sum of the wholly taxable receipts and the allocable receipts. It is of course apparent that the least this fraction could be was one-third. The defects of this factor led to the invalidation of the formula.

The average of these three factors was the allocation percentage, subject to a minimum of  $33\frac{1}{3}$  per cent and maximum of  $66\frac{2}{3}$  per cent. The measure of the tax was the wholly taxable receipts added to the product

of the allocable receipts and the allocation percentage. Although initial opposition to this formula was widespread, in recent years it was generally thought to have been approved by the New York Court of Appeals in *Matter of Olive Coat Company, Inc. v. McGoldrick*.<sup>3</sup>

### The Gulf Oil Case

Gulf Oil Corporation, a taxpayer doing business within and without the City, attacked the tax (according to the opinion) on three grounds: *first*, on the inclusion of any portion of the receipts from interstate commerce in the measure of the tax; *second*, on the ground that the formula did not reasonably and lawfully measure the tax; and *third*, on the ground that Gulf was discriminated against in favor of those engaged solely in intrastate activities.

The Court of Appeals last year decided the first point against the taxpayer, but then went on, in a consideration of the other two points, to invalidate the formula.<sup>4</sup> The Court objected specifically to the fact that the receipts factor could not be less than one-third, and to the fact that there was a minimum allocation percentage of  $33\frac{1}{3}$  per cent. The Court said that these points had not been considered in the *Olive Coat* case.

In disposing of the case, the Court of Appeals remitted the matter to the Comptroller for further proceedings not inconsistent with its opinion. This language obviously called upon the Comptroller for a new formula, but it had one further significance. Gulf, having won on two points of three, proceeded to appeal to the Supreme Court of the United States the point it had lost. That court refused to consider its appeal for the reason that only final orders are appealable; the remittance of the matter to the Comptroller by the New York Court of

<sup>3</sup> *Matter of Olive Coat Company, Inc. v. McGoldrick*, 287 N. Y. 769, 40 NE 2d 642 (1942).

<sup>4</sup> *Gulf Oil Corp. v. Joseph*, supra, note 1.

Appeals was not a final order. Gulf will ultimately get a final order, and it appears that its attack on the tax will be continued.

### **The New Formula**

On March 4, 1955, the Comptroller issued the new formula.<sup>5</sup> Instead of a three-factor formula, this is technically, at least, a two-factor formula composed of a wages factor and a property factor. There are, however, two receipts fractions which are used in each of the other factors. The receipts numerator factor is allocable receipts over allocable and wholly taxable receipts. The receipts denominator factor is allocable receipts over allocable and nontaxable receipts.

The numerator of the property factor is the product of the property in New York City and the receipts numerator factor. The denominator of the property factor is the sum of the property factor numerator and the product of the property outside New York City and the receipts denominator factor.

The wages factor is constructed on the same scheme, with the numerator the product of New York City wages and the receipts numerator factor, and the denominator the sum of the wages numerator and the product of outside-City wages and the receipts denominator factor.

The property factor and the wages factor are averaged to obtain the allocation percentage. There is no longer a minimum allocation percentage, but—and this was the most surprising feature of the new formula to many—the 66⅔ per cent ceiling has been retained.

In cases where there are receipts from foreign commerce, these receipts are divided into "New York City foreign commerce receipts" (receipts arising from exports originating and imports terminating in New York

City) and "Outside New York City foreign commerce receipts" (receipts arising from exports originating, and imports terminating outside New York City). The first is added to the denominator of the receipts numerator factor, and the second to the denominator of the receipts denominator factor. The formula is then applied in the manner described above.

### **Comment**

The new formula is in many ways a considerable improvement. In the first place, the objections of the Court of Appeals have been met; the 33⅓ per cent floor has been completely eliminated and, in a sense, so has the objectionable receipts factor. In the second place, where before two of the three factors were constructed on a basis to which the third bore no resemblance, both factors of the new formula follow one pattern.

The pattern, however, makes certain questionable assumptions. New York City property or wages is assumed to produce all the wholly taxable receipts and a part of the allocable receipts. The property or wages outside New York City—and note that the limitation "within the United States" no longer appears—is assumed to produce all the nontaxable receipts and the part of the allocable receipts not assignable to New York City property or wages. The numerators thus seek to reflect that part of New York City property or wages devoted to the production of allocable receipts, and the denominators the total property devoted to the production of allocable receipts.

The defect in this proposition is, of course, that not all of the wholly taxable receipts is attributable to New York City property or wages. Intrastate transactions can give rise to wholly taxable receipts produced in part by property and wages outside

<sup>5</sup> Bulletin 1955-2 of the Special Deputy Comptroller, appearing at § 195-156, C.C.H. New York Tax Service, Vol. 4.

the City. The numerators of the new formula, then, apply to City property or wages a receipts numerator factor the denominator of which is not entirely attributable to City property or wages.

The expectation exists that Gulf Oil Corporation will continue its attack on the proposition that the City may include some portion of the receipts from interstate commerce in the measure of the tax. Whether or not this attack is successful, it appears that an exploration of the City's position that receipts from certain intrastate transactions are wholly taxable would then

be in order. If the Gulf Oil Corporation succeeds, the formula will no longer trouble us; if Gulf should fail, then perhaps the inconsistency noted above may be the new formula's Achilles' heel.

### Conclusion

The Comptroller of the City of New York has promulgated a complex and ingenious new formula. While it is probably successful in meeting the objections of the Court of Appeals in *Gulf Oil Corp. v. Joseph*, it still contains a defect which may cause it to be rejected by the courts.

### Some Problems of the Local Practitioner

(Continued from page 278)

to the individual practitioner than to others. Some of these are:

1. Continuation of the task of raising standards.
2. Defending the CPA's rightful position in tax accounting.
3. Provision of high-level assistance and counsel to local practitioners.
4. Protecting the practice of the local practitioner in the event of his death.

5. Continuation of efforts to convey to the business world the high professional status of the CPA.

All of these as well as many other problems are receiving the continuing attention of your State Society and the American Institute of Accountants. You can serve yourself well if you will take an active interest in both organizations.

### Thoroughbred Racing Association Accounting

(Continued from page 284)

senting "short payments" would soon destroy public confidence in racing. Furthermore, with State and local taxing authorities involved, payments to them must be accounted for properly and promptly.

I want you to know that it was a pleasure for me to be with you this evening. I hope that this brief outline has given you some insight into the methods of accounting used by Thoroughbred Racing Associations.

# Current Trends in Accounting—IX

By LEO ROSENBLUM, C.P.A.

*Some Capsules Reflecting Modern Practices  
and Current Problems and Conditions*

(Concluded from April issue)

## Accounting Theory

### Book Value

"What is book value?" ask Maurice H. Stans, CPA, president of the Institute, and John P. Goedert, CPA, his partner, of Alexander Grant & Company, Chicago, in their article in the January, 1955, issue of *The Journal of Accountancy*<sup>51</sup>. They analyze the significance of the term "book value", having recourse in the process to the definitions found in accounting literature and in court decisions, and conclude that in their case studies suggest the need for attention by accounting research groups to two points: "The lack of an authoritative and comprehensive definition of book value," and "The desirability of an alternative term for book value."

In *The New York Times*<sup>52</sup> J. E. McMahon discusses book value, his contribution being titled "Very Few Stocks Traded 'At Book'," and sub-

captioned: "But Theoretical Value of an Issue Has Its Uses, Taken with Other Factors".

Mr. McMahon asks: "How good is book value as a measuring rod of a stock?" He points out that the relationship of book value to market value appears to be "quite distant", and notes that "where book value has some meaning is where it shows what a company has to work with and how much it earns on this book value over a period of time." However, this, too, "can be an illusory point", since differing industries have different earnings ratios.

"As a guide to investors", however, "book value may have its most useful function when the general level of stock prices is either abnormally low or abnormally high—by adding weight to other carefully considered factors that encourage investment or liquidation."

### Drop the Pennies

"A Case Study in Elimination of Cents in a Company's Accounting Records" is provided in *News Bulletin*<sup>53</sup> (of the Massachusetts Society of CPAs) by Ralph W. Crouch, CPA, associated with the staff of Peat, Marwick, Mitchell & Co.

He describes the saving in time and expense to a company through the elimination of the recording of pennies in most of its accounting records and in all its reports, including the annual report and the report to the Securities and Exchange Commission.

When the company transferred to this "centsless accounting" all balances in the accounts were brought to the nearest even dollar, except the balances of cash, accounts receivable, and accounts payable.

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<sup>51</sup> Vol. 99, No. 1, pp. 38-46.

<sup>52</sup> February 15, 1955.

<sup>53</sup> Vol. 28, No. 5, January, 1955, pp. 19-22.

Also, bookkeeping and recordkeeping time was saved by avoiding the entering of zeros or dashes in the cents column when entries were made in "whole dollars" in the voucher register, general ledger, expense ledger, and in subsidiary ledgers.

Of course there were some inconveniences, as the employees found.

For example:

- "1. In preparing cash or journal vouchers, additional time is required in typing an extra line for the amount of the cents variation.
2. There seems to be greater chance for error, as employees sometimes add a decimal in error. . . .
3. Typists in preparing reports often inadvertently add a decimal in the wrong place, and several journal vouchers a month have to be re-typed.
4. Additional time is necessary in training new employees in the operation of the procedure.
5. Substantial additional time is required at the time the procedure is adopted in eliminating cents in subsidiary records and in bringing the details into agreement with the general ledger controls.
6. The company prepares its monthly operating statements on a comparative basis, and additional time was required each month during the first year following the adoption of the procedure, in eliminating cents in the comparable accounts for the preceding year. . . ."

Generally, Mr. Crouch reports: "for this company, the time saved in the maintaining of detailed plant records alone more than offsets the inconveniences. . . ."

He concludes: "The nature and volume of the transactions to be recorded will be the determining factors as to the desirability of the installation."

### Foreign Exchange

"Accounting principles on the treatment of foreign exchange go by the board when foreign exchange breaks down," points out a columnist in the "Finance & Commerce" section of *The Accountant*<sup>54</sup>. He notes:

"The Argentine angle on the foreign exchange problem is seen in the accounts of the Tecka (Argentina) Lands Co., Ltd., which reports a 'highly satisfactory' peso profit of 1,579,000 pesos, an increase of 320,000 pesos. There, as the chairman, Brigadier Hugh Crosland says, the satisfaction ends because the company is still not allowed to cross the foreign exchange bridge from pesos into sterling.

"The Company raises sheep and cattle in Chubut Territory, Argentina, and evidently makes a good job of it, but has not paid a dividend for the past five years [;] . . . like others, has not yet even received the 5 per cent on its capital invested in Argentina as laid down in Argentine regulations."

### Next Year's Depreciation as Current Asset

J. E. Smyth, chartered accountant, editor of *The Students' Department in The Canadian Chartered Accountant*<sup>55</sup> reports a query raised by a student.

Well established is the practice concerning long-term liabilities reported in balance sheets, under which such liabilities are classified as current liabilities at the year-end preceding maturity, provided refunding is not in prospect nor payment anticipated out of sinking fund assets not themselves classified as current assets. In brief, "A long-term liability is, as it were, kicked upstairs just before it is retired." Under this reasoning, why would it not be appropriate, the student asked, to follow substantially the same procedure concerning long-term or fixed assets? Why should not "next year's depreciation expense . . . be classified as this year-end's current asset?"

Depreciation expense, notes Mr. Smyth, "may be defined . . . as the cost of those services provided by fixed assets which, it is estimated, have been sold to customers in the current year. As for next year's depreciation expense, it will be realized in a similar way next year." Accordingly, he asks, "What . . . is the difference between that portion of the cost of fixed assets which will be realized in revenue in the

<sup>54</sup> Vol. CXXXII, No. 4178, January 15, 1955, p. 68.

<sup>55</sup> Vol. 65, No. 5, November, 1954, p. 295.

following year, and the cost of inventories, and prepaid expenses in general, which will be realized in a similar way? If inventories and other prepaid expenses are to be classified as current assets, why not alter next year's depreciation expense?"

#### Electronics

##### Medium-Sized Company

Do your clients have record-keeping problems which may be settled by the installation of large-scale electronic data processing devices? How can you find out? And if they do have such problems, which of the present systems is best?

R. D. Dotts, manager, Planning and Coordinating Department, Pacific Mutual Life Insurance Company, discusses this subject in the *Journal of Machine Accounting Systems and Management*<sup>56</sup>. In his company a committee was organized to keep abreast of developments in the field of electronic processing machines and to determine whether such machines were practical for the company. Also, if it was found that the machines were practical, the committee was to ascertain what equipment would be most suitable. Finally, it was to be prepared to make recommendations concerning the acquisition of necessary machines and to guide the organizational and system changes after the machines were installed.

How this all worked out for the Pacific Mutual Life will interest our members concerned with electronics as systems aids.

##### From Theory to Practice

E. W. Workman, Controller, The Morgan Crucible Company, Ltd., discusses "Electronic Computer Development. From Theory To Practice," in *The Accountant*<sup>57</sup>.

In a two-page paper, he describes planning for the use of an electronic computer in a three-thousand employee plant, following the project from preliminary investigation to the completion of the first job. Here, truly in capsule form, is presented the history of an electronic installation from beginning to end.

#### Auditing

The Institute's *Newsletter*<sup>58</sup> reports that "a new AIA committee on electronic accounting has been authorized by the Executive Committee to investigate the procedures necessary to follow for satisfactory auditing of electronically maintained accounts". The committee is made up of five Institute members, headed by Joseph Pelej, CPA, of New York, as chairman.

#### Recruiting for the Profession

##### The Ideal Employee

Frank S. Calkins, CPA, of Richmond, Virginia, addressed the 1954 annual meeting of the Virginia Society of Public Accountants on the subject, "What the Accounting firm Wants in an Employee"<sup>59</sup>.

Mr. Calkins outlined the personal characteristics, skill and education sought in an employee. While technical skill can be acquired, he said, certain personal qualities are necessary so that one "may have a firm foundation upon which to build". His "over twenty-five years of observation of accountants" convinced him that no man "was able to change appreciably his personal traits"; but Mr. Calkins saw "many men of seeming mediocre skill who . . . developed into excellent technicians." He therefore concluded that the personal characteristics of those who seek to enter the profession should be considered carefully.

<sup>56</sup> Vol. 5, No. 11, December, 1954: "An Approach to Electronics by a Medium-Sized Company," pp. 5, ff.

<sup>57</sup> Vol. CXXXI, No. 4166, October 23, 1954, pp. 426-427.

<sup>58</sup> Vol. 5, No. 8, November, 1954, p. 4.

<sup>59</sup> *The Virginia Accountant*, Vol. VIII, No. 2, October, 1954, pp. 4-13.



Mr. Calkins discussed each of these points as factors in the appraisal of members of accounting staffs: appearance; intelligence; stability; energy; the inquiring mind; tact; thoroughness; self-reliance; teamwork; discipline; orderly habits; backgrounds and occupations of parents; imagination; health; maturity.

#### New South Wales

*The Chartered Accountant in Australia*<sup>60</sup> reports that in recruiting juniors for accounting staff positions in Australia, the American Institute of Accountants' sound film, "Accounting—The Language of Business", has been put to use in New South Wales.

#### Taxation

##### Advanced Training in the Internal Revenue Service

Professor Charles J. Gaa, Director of the Advanced Training Center for the Internal Revenue Service at the University of Michigan, describes the project in the January, 1955, issue of *The Accounting Review*<sup>61</sup>. He presents a calendar reflecting the speed with which the program got under way. The law (Public Law 374, 83rd Congress) was passed on May 28, 1954, and classes began on September 20, 1954.

According to regulations of the Secretary of the Treasury: the purpose of the advanced training is as follows: "the advancement of the public service by strengthening the tax enforcement system of the Federal Government and by inculcating the highest professional and ethical standards among Internal Revenue personnel."

The curriculum of the course includes these required studies: Corporate Accounts and Statements; Financial Policies; Auditing; Income Tax—

Accounting; Income Tax—Law.

In addition, each trainee is permitted to choose one course from the following seven electives: Economics of Enterprise; Cost Accounting; Internal Accounting and Control; Elementary Statistics; Principles of Organization; Business Statistics; Retirement Plans.

Of course, Professor Gaa points out, "Intensive study is now being given to the curriculum and grading questions on the basis of actual experience, in order to make all advisable changes effective before the second semester training begins."

##### Substantiating Deductions for Traveling Expenses

The substantiation of deductions for traveling expenses, the determination whether a taxpayer is in travel status, and the deductibility of automobile and other transportation expenses incurred by an employee are discussed in Revenue Ruling 54-497.

Although "each case must be decided on its own particular facts," it is suggested that "an understanding of the principles outlined [in the Ruling] . . . will materially facilitate the solution of many of the recurring problems concerning traveling and transportation expenses claimed by employees on a basis satisfactory to both the taxpayer and the Government."

The term "principal or regular post of duty" (of an employee) is discussed at length.

##### Was Your Wife on the Trip, Too?

Revenue Ruling 55-57 discusses "the deductibility of amounts expended by a taxpayer for the traveling expenses of his wife who accompanies him on a business trip or to a business convention." Such expenses are non-

<sup>60</sup> Vol. XXV, No. 6, December 20, 1954, pp. 365-366.

<sup>61</sup> Vol. XXX, No. 1, pp. 28-36: "An Experiment in Staff Training: The Advanced Training Center of the Internal Revenue Service."

deductible personal expenses "unless it can be adequately shown that the wife's presence has a bona fide business purpose."

Included among the cases discussed were those of a wife who was stated to be the owner of the business enterprise involved, and one who, herself trained as a singer, "coached her husband in preparation for his singing roles" and performed other services in connection with his tours.

### Sales Tax Chart

Writing in *Taxes*, Heinz Ulrich, tax accountant for an oil company located in New York City, points out that "the total man-hours spent gathering all the data necessary for compliance with simple sales tax requirements over a period of a year may well surpass the total man-hours used in making up the federal income tax return"<sup>62</sup>. It is his company's practice to construct charts on twenty-one column accounting paper to list the sales tax requirements of the various states.

The charts are sectionalized, each containing the data for a number of states. For example, the chart presented in Mr. Ulrich's article covers Maine, Connecticut, and Rhode Island, as well as New York City. The data are tabulated under these subdivisions: Period of Returns; Due Dates; Extension of Time; Refunds on Returned Property; Bad Debts; Transportation Charges; Credit for Tax-Ins; Exemption Certificates; Exemption Certificates on File; Interstate Sales: (1) F.O.B. Origin, (2) F.O.B. Destination, (3) Delivered to Out-of-State Customer; and, last, Can Tax Be Absorbed?

### How Long Must a Taxpayer Keep His Records?

Arnold P. Soney, CPA, discusses this question in the *News Bulletin* of the Massachusetts Society of CPAs<sup>63</sup>.

He presents a long list, reflecting the length of time records should be kept, subdivided as follows: Tax Statutes of Limitations—Federal Income Taxes; Miscellaneous Federal Taxes; State Unemployment Insurance Taxes—Massachusetts; Other States' Taxes—Connecticut, Rhode Island, New York; Fair Labor Standards Act.

This is followed by a retention schedule containing these further subdivisions: Records to be retained for six to seven years; those to be retained for from two to three years; those to be retained for one year or less. The retention of microfilm records and tabulating records are also discussed.

Mr. Soney's paper merits study by our readers.

Readers will doubtless recall the article by George N. Farrand, CPA, of our Society in *The New York Certified Public Accountant* of December, 1948<sup>64</sup>. Entitled "Preservation of Accountants' Records," it dealt with "the preservation and/or destruction of records, working papers, reports, and other material belonging to and in the possession of the practicing certified public accountant . . . [w]as concerned only incidentally with such material as belongs to and is in the possession of the accountant's clients"<sup>65</sup>.

### Net Worth Method

In his section, "New Developments in Fraud and Negligence," in the January, 1955 issue of *The Journal of Taxation*,<sup>66</sup> Harry Graham Balter discusses the condition in which the

<sup>62</sup> "Sales Tax Charts as Time-Saving Devices," Vol. 33, No. 1, January, 1955, pp. 50-51.

<sup>63</sup> Vol. 28, No. 4, December, 1954, pp. 15-25.

<sup>64</sup> Volume XVIII, No. 12, pp. 881-889.

<sup>65</sup> *Ibid.*, p. 881.

<sup>66</sup> Vol. 2, No. 1, p. 42, "Net Worth Method Used Though Books Exist."

taxpayer's books "are shown to be so incorrect or so inadequate that they fail to reflect true income," and whether under such circumstances the Commissioner may resort to the indirect method of proving unreported income by showing increase in net worth.

This writer points out that while "tax men generally" have apparently assumed that the Commissioner may use this method only under circumstances like those described above, question arises concerning the situation where "superficially or on the surface the taxpayer has a complete set of books." He poses the problem whether the Commissioner may under such circumstances resort to proof of increase in net worth to show that the books are inadequate or whether he must prove their inadequacy in some other fashion.

"The present trend in the Tax Court" appears to permit the Commissioner to use the net worth estimate under these circumstances, despite the fact that the taxpayer or his accountant would testify that the books were correct and adequate. The Court's current doctrine on the point, notes Mr. Balter, "seems to have been implemented by *Morris Lipsitz*, 21 TC 917, and followed in *Estate of W. D. Bartlett*, 22 TC 151 and *H. A. Hurley*, 22 TC 157."

### Ethics

#### Orienting the Successor Accountant

As has been noted earlier in this column,<sup>67</sup> in Great Britain when accountants are invited by prospective clients to take over engagements from other accountants, the new accountants must communicate with their predecessors before accepting the engagements. This is required under the rules of ethics of the British professional societies.

The following account on this subject is from "Days from my Diary," a column conducted by "A. Martyred Accountant" in *The Accountant*.<sup>68</sup>

"Monday, 22nd:—Month ago relinquished X. & Co., Ltd., audit with relieved sigh. Usual letter from successor now arrives. Would like to reply that audit staff are put in cold, dirty, ill-lit room, abused at intervals, expected to do three-quarters of bookkeeping for bare audit fee from inadequate records by impossible date, and that X, who charges trade expenses with anything from his underwear to his betting losses, will not accept corrections without vituperative rows. Recall I received no inklings from my predecessor; nevertheless, concoct letter containing gentle but unmistakable hint to new auditor that he should come and see me, poor devil!"

#### Obligations of Members of Georgia CPA Society

Article XI of the Code of Ethics of the Georgia Society of Certified Public Accountants provides in part:

"It shall be the duty of each member of this Society to report to the Board of Trustees, or an appropriate committee, any violation of the Code of Ethics or any other matter affecting the practice of accountancy concerning which he may have knowledge. Further, it shall be the duty of any member to notify the Board of Trustees of any action affecting the profession which he has initiated or of which he may have knowledge."<sup>69</sup>

This rather interesting interpretation of the above rule is provided in the Society's *Bulletin*:

"The Board of Trustees has not laid down rules by which this section may be interpreted. However, it is their opinion that a suit in which a member of our profession is involved would come under this provision of the By-Laws. Oftentimes you may be in doubt as to whether an action or event should be reported to them. A member involved should not be the judge of whether the rule applies to him or to his case."

The Society appears to interpret the phrase "affecting the practice of accountancy" quite literally.

<sup>67</sup> "Current Trends in Accounting-VII," in Vol. XXIV, No. 9, September, 1954, p. 573.

<sup>68</sup> Vol. CXXXI, No. 4171, November 27, 1954, p. 549.

<sup>69</sup> *Bulletin* (of the Georgia Society of Certified Public Accountants), Vol. 22, No. 4,

### To Be Avoided

Here is an abstract from the report of Ohio Society of CPAs' Committee on Law Enforcement and Ethics:<sup>70</sup>

"A major problem before the profession in the matter of ethics relates to the CPA's part in advertising programs, some of which have resulted in his appearance on television or the reproduction of his letterhead in newspaper display advertisements. It is agreed that publicity for the profession or for its members growing out of public service activities should not be frowned upon but that on the other hand it is at least poor taste for an accountant to permit his name to be used as the verifier of claims or statements not related to financial information or requiring the services of a skilled accountant. The Ethics Committee of the American Institute of Accountants is also at present working on this problem."

### Statistics in Accounting

#### Cost Control

Lawrence L. Vance, professor of accounting at the University of California, writes on "Capsule Cases in Statistical Cost Control" in the *N.A.C.A. Bulletin*.<sup>71</sup>

He considers the applications of statistical theory as cost control devices, using the term *cost control* "in a broad sense," that is, as something "more than a cost accounting system . . . [since it] involves other devices and . . . executive action."

When based upon the theory of probability, "sampling . . . permits us to estimate in advance the degree of accuracy of the sample and to test the degree of accuracy in retrospect."

Professor Vance considers cases in statistical cost control involving the following situations: the distribution of telephone equipment by type of apparatus; the division of freight receipts among cooperating railroads

on an inter-line haul; a department store inventory; the quality of raw material delivered to a mill by each of two companies, and intermingled and processed.

Statistical sampling theory, Professor Vance concludes, being "based upon the mathematics of probability," offers the possibility of "improving the accuracy and economy of compiling cost data as well as other information used in industry."

#### Sampling: Prorating Delivery Costs

Werner Z. Hirsch, assistant professor in the Economics Department of Washington University, St. Louis, discusses "A Sampling Technique for Prorating Delivery Costs" in *The N.A.C.A. Bulletin*.<sup>72</sup> His paper provides additional illustration of the important contribution statistics can make to the solution of accounting problems. Professor Hirsch discusses the procedure employed in prorating delivery costs based on the sampling technique, and compares it with the former procedure. He illustrates how the technique was applied; what size of sample was required; what sample selection should be made when monthly deliveries vary widely; how to handle variation in costs per parcel.

The professor believes that the department store "with its large-scale operation" will provide a fruitful place for achieving cost reduction by sampling methods.

### Management Accounting

#### When Disaster Strikes

Edwin E. McConnell and William H. Perks, controller and member of the controller's staff of the Norton Co., Worcester, Massachusetts, discuss "The Controller's Role when Disaster Strikes," in *The Controller*.<sup>73</sup>

November, 1954, p. 3.

<sup>70</sup> *The Ohio Certified Public Accountant*, Vol. XIII, No. 4, Autumn Issue, 1954, p. 198.

<sup>71</sup> Vol. XXXVI, No. 5, Section 1, January, 1955, pp. 682-688.

<sup>72</sup> Vol. XXXVI, No. 6, Section 1, February, 1955, pp. 805-812.

<sup>73</sup> Vol. XXIII, No. 1, January, 1955, pp. 14, ff.

They offer suggestions concerning insurance and insurance settlements based on their company's experience following a tornado which, in 5 minutes, caused millions of dollars of damage to the company's new winding machine plant.

The controller, they tell us, "should assume . . . responsibility for the preparation of all claims and their negotiation as most claims are based on accounting facts."<sup>74</sup> A strict ruling should be adopted prohibiting personnel from making speeches or talking to outsiders about negotiations or claims: "such information to outsiders may embarrass your proceedings."

These matters are considered at some length: the type of insurance policy desirable; relations with the insurance adjuster; agreements on matters of policy with insurance company representatives; the need for appraisal companies; business interruption insurance; how the claim should be processed; determining the amount of the loss in production and the loss in profit; fixed costs and reimbursable expenses; the period of interruption; preserving records; summarizing key claims data.

#### The Accountant in Industry

S. Dixon, chartered accountant, and director and secretary of the Midland Tar Distillers, Ltd., reviewed the problems of an accountant in industry at a course offered by The Institute of Chartered Accountants in England and Wales at Oxford last September.<sup>75</sup>

He pointed out that some people "are mesmerized by figures," cautioned the accountant against "the terrible temptation of allowing himself to be the slave of figures," and offered three other rules for the industrial accountant.

Most important, should be the realization that accountancy is not an end in itself. The function of the account-

ant in industry is to "provide a service and the corollary of that statement is that the service must be what is required by those who use it and not what those who give it think it ought to be. . . ." Second, the accountant must learn as much as he can about the practical problems facing management; must look into and understand "the practical processes which lie behind the figures which are continually streaming through his office."

Third, the accountant "must learn to keep a sense of proportion." Mr. Dixon reported comment that at a recent conference it was observed of accountants that they "could never be persuaded to work to less than several places of decimals, whereas what general management usually wanted was an informed guess." Although Mr. Dixon considered the accusation not altogether just, he agreed that when accountants transfer to industry "they must consciously and deliberately set about the task of equipping themselves with a new set of values."

#### General

25,000

The American Institute of Accountants announced early this year that its membership had reached the total of 25,000, having "skyrocketed . . . from only 5,400 fifteen years ago. . . ."<sup>76</sup>

The Institute was founded in 1887. It is the only national organization of CPAs in the United States.

#### Foreign Journals

The following is a list of the contents of a Fall, 1954 issue of *Roe Heshbon Musmach (The Public Accountant)*, organ of the Association of Public Accountants and Auditors in Israel:<sup>77</sup> Professional Ethics; Incentive Bonuses; Auditing Standards (II); Income Tax Problems; Bonus Shares; "The Income Tax Expert";

<sup>74</sup> *Ibid.*, p. 15.

<sup>75</sup> "General Problems of an Accountant in Industry—I," in *The Accountant*, Vol. CXXXI, No. 4170, November 20, 1954, pp. 525-527, 529-534.

<sup>76</sup> News release, January 28, 1955.

<sup>77</sup> Vol. 5, No. 28, September-October, 1954.

Valuation of Goodwill; Audit of Sick Funds; Training for Accountancy in Holland; Taxation in Denmark; Taxation Cases; Income Tax Section; The Student's Section; Association News.

### Brazilian Conference

In an earlier issue we reported the forthcoming third Inter-American Accounting Conference in Sao Paulo, Brazil, in November, 1954.<sup>78</sup> President Maurice H. Stans of the Institute headed the American delegation of 17 which attended the convention. Mr. Stans, vice president of the Conference, acknowledged the address of welcome for the English-speaking countries. He also presided over the first plenary session.

Mr. Maurice E. Peloubet of our Society, a member of the Council of the American Institute of Accountants, presented a paper on "The Cost Accountant in the Modern World," which was reviewed in the Brazilian press and reprinted in full in one of the newspapers.<sup>79</sup> Mr. Peloubet also appeared as a panel member on a television show, aided by an interpreter.

### Jobs for Systems Accountants

*The Controller*<sup>80</sup> reports the Department of Defense's interest in additional qualified systems accountants to work in Washington, D. C., and vicinity. Salaries will range from \$7,040 to \$10,800 annually.

The Department of Defense considers this project of recruiting qualified systems accountants "a major step toward the implementation of improvements in the accounting systems in the many and varied types of activities within the Department of Defense."

Further information is available from the Board of U. S. Civil Service Examiners, Department of Defense, The Pentagon, Washington 25, D. C.

### Wanderlust

A recent issue of *The Accountant*<sup>81</sup> reports accounting vacancies in Khartoum, Sudan, Aden, South America, Ceylon, Kenya, Nigeria, Northern Rhodesia, India, Malaya, the West Indies, and Gibraltar.

### Tribute to CPAs

CPAs will be glad to learn of the appointment of Edward D. Wilcox, CPA, of Chicago, former president of the American Institute of Accountants, as a member of the three-man arbitration panel whose task will be to consider the validity of the increase in Cincinnati bus fares granted last year.

Mr. Wilcox was selected by the other two members of the arbitration panel, one a representative of the bus company and the second representing the city. They were guided in appointing Mr. Wilcox, the other arbitrators stated, by these three principles:

"The appointee should be a CPA since accounting is involved.

He should be a man of high intelligence and of national stature in his profession preferably the president or a past president of the AIA.

He should be completely honest and independent."<sup>82</sup>

### Budgeting

"How A Super Market Chain Started Budgeting" is described by Lloyd D. Tarlin, Vice President of Stop and Shop, Inc., Boston, Massachusetts, in the *N.A.C.A. Bulletin*.<sup>83</sup>

He presents an outline of budgeting procedure,<sup>84</sup> made up of four

<sup>78</sup> "Current Trends in Accounting—IV," in Volume XXIII, No. 11, November, 1953, p. 692.

<sup>79</sup> Reported in *The Mississippi Certified Public Accountant*, Vol. VIII, No. 3, Spring, 1955, p. 24.

<sup>80</sup> Vol. XXIII, No. 2, February, 1955, p. 62.

<sup>81</sup> Vol. CXXXII, No. 4178, January 15, 1955, pp. xxiv-xxv.

<sup>82</sup> *The Ohio Certified Public Accountant*, Vol. XIII, No. 4, Autumn Issue, 1954, p. 181.

<sup>83</sup> Vol. XXXVI, No. 4, Sec. 1, December, 1954, pp. 533-537.

<sup>84</sup> *Ibid.*, p. 534.



steps: (1) the data to be furnished to the divisions; (2) the preparation of divisional budgets; (3) approval of the budget by the general manager; and (4) the evaluation of the results as against the plan.

The problem of budgeting "is never over." Mr. Tarlin finds that the plans for a period are due before the results of the preceding period have become available; that problems arise in different areas each period; that these are brought to light by the budget and are high-lighted, thus making practical undertaking corrective action.

### Municipal Accounting Check List

*The Mississippi Certified Public Accountant*<sup>85</sup> presents the following check list, prepared from a questionnaire of the Municipal Finance Officers Association of the United States and Canada, of Chicago, Illinois:

1. Accounts should be centralized under the direction of the Municipality's chief finance officer.
2. Financial reports should be issued by or under the supervision of the Municipality's chief finance officer.
3. Accounting work should be so subdivided that employees keeping records will not have access to the assets controlled by such records.
4. Pre-numbered tax-receipt forms, license forms, etc. should be used and properly accounted for.
5. Responsibilities should be established and authority should be delegated so that each accounting employee can be held responsible for his work, and so as not to have duplication of effort.
6. Accounts should be audited by a qualified independent accountant.
7. General accounting system should be on a double entry basis.
8. Accounting system should include adequate budgetary records so that exact balance of each budget item is readily available.
9. Either accrual or modified accrual basis of accounting should be followed.
10. Funds of the municipality should conform to the classification recommended by the National Committee on Governmental Accounting.
11. Revenues should be classified by source.
12. Expenditures should be classified by function, organization unit, activity, character and object.
13. Appropriation accounts should be encumbered as soon as purchase orders are placed or contracts entered into.
14. Fixed assets and bonds payable should be excluded from the General Fund balance sheet.
15. Records of fixed assets should be kept.
16. A physical inventory of movable fixed assets should be taken.
17. A physical inventory of consumable supplies should be taken.
18. A cost accounting system should be maintained for public works activities or other activities subject to cost measurement.
19. An annual financial report should be issued.
20. The same terms should be employed in the budget document, the accounts, and the financial statements.

<sup>85</sup> Vol. VIII, No. 2, Fall, 1954, pp. 13-14.

# New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

## Gross Receipts— Interstate Commerce

Following the denial by the United States Supreme Court of a writ of certiorari in the *United Piece Dye Works* case<sup>1</sup> the Special Deputy Comptroller has amended Articles 106 and 209 of the regulations pertaining to the General Business and Financial Tax Law. The amended regulation now provides that a person is not subject to the tax, and need not file returns, if he is engaged in the business of selling goods or rendering dyeing or similar services if such person maintains his principal office and all plants, factories and warehouses outside New York State, if all orders are accepted at an office outside the State, and if all goods are shipped directly to customers in New York City from points outside the State. Furthermore, activities in the City must be confined to solicitation and sales promotion activities.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928, and a member of the American Institute of Accountants since 1922. He is a member of the New York Bar and Professor of Law at St. John's University.

Mr. Harrow is a past Vice-President of the Society. He is now serving as Chairman of the Committee on Publications and is a past Chairman of the Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

The bulletin issued by the Deputy Comptroller further provides that the following activities will not make such persons taxable:

1. Maintenance of a sales solicitation or advertising office in the City.
2. Maintenance of service representatives in the City to service accounts, if no separate charge is made for such services.
3. Maintenance of a display room in the City exclusively for the display of sample merchandise.
4. Representation in the City by manufacturer's sales representatives, independent sales agents, or resident salesmen.
5. Adjustment and settlement of customer's claims at an office in the City.
6. Maintenance of bank accounts with banks in the City, or use of a New York City bank as registrar, transfer agent, or dividend- or interest-paying agent.

It should be noted that if a person maintains an office, factory, stock of goods or warehouse within the City from which goods sold are shipped to customers, such person is subject to the tax.

## Sales Tax

The Appellate Division<sup>2</sup> held recently that a publisher of comic books is subject to the New York City sales tax upon the purchase from various commercial artists, pencillers, letterers and inkers of all rights to the finished product. The publisher had the right to correct, retouch and otherwise change the art board after it had been delivered by the artist. The commercial artists, pencillers, letterers and inkers were paid an agreed amount per page for drawing and lettering work.

<sup>1</sup> *Matter of United Piece Dye Works v. Joseph*, 282 App. Div. 60; aff'd 307 N. Y. 780; cert. den. — U. S. —, January 10, 1955.

<sup>2</sup> *Hillman Periodicals, Inc. v. Gerosa*, 1st Dept., February 23, 1955.

The work was performed on card-boards or art boards, sometimes furnished by the publisher. The artists retained no rights in the finished products. The art boards were either consumed in the engraving process or were discarded.

The court held that something more was sold than a mere right to reproduce. There was an integration of the services rendered into tangible personal properties. The court distinguished this case from *Matter of Trissell v. McGoldrick*<sup>3</sup> where the vendor retained title to the integrated product and could still sell it after its return by the purchaser. The law said the court does not recognize a variance between the value of the services and the value of the personal property into which the services are integrated. Nor is it material that the product is virtually valueless to anyone but the purchaser.

Two judges dissented with respect to the tax on the amounts paid to pencilers, letterers and inkers. Such payment they held were for intangible personal services or for processing, fabricating or printing of tangible personal property. The tangible art boards were merely incidental. The fabrication amendment<sup>4</sup> is not applicable to services unless such services, regardless of their value, are rendered to a physical object that is improved by the services and the product by intention and function is primarily the physical object. The dissent held that the transaction is the rendition of services for compensation. The services happened to be evidenced by a piece of paste-board. The services of necessity had to be represented on a physical object. The services could have been performed by an employee inside the shop. We should not be surprised if the Court of Appeals reverses this decision and upholds the dissenting opinion.

## Effect of 1954 Code on New York State Franchise Tax

Deputy Commissioner Kassell in a letter to Prentice-Hall, Inc.,<sup>5</sup> states that the deduction for estimated expenses under Section 462, the use of accelerated methods of computing depreciation under Section 167, and the deferment of prepaid income under Section 452 will be accepted in determining net income under Article 9A of the Tax Law. Section 208, subdivision 9, in defining entire net income, states that it shall be presumably the same as that which is required to be reported to the Treasury Department. The federal changes would not apply under the personal income tax law or the unincorporated business tax, since Articles 16 and 16A do not contain any provisions making net income dependent upon income reported for federal purposes.

Congress is presently considering the retroactive elimination of Sections 452 and 462. If the amendment to the code is adopted it will affect the New York franchise tax as well.

## Reserve for Estimated Expenses

Our president, J. S. Seidman, as chairman of the American Institute of Accountants' Committee on Federal Taxation appeared before the Ways and Means Committee on March 17th to speak in opposition to the two bills that would retroactively eliminate the provision in the law allowing a deduction for estimated expenses. The bill was prompted by Secretary Humphrey's concern that the revenue would be seriously affected by this provision, and that the scope of the provision may get out of hand and far beyond the original intent.

Jack made a masterly statement. He felt that both problems could "be corrected easily and speedily, without

<sup>3</sup> 300 N. Y. 370.

<sup>4</sup> Adm. Code, sec. A 41-1.0, subd. 7.

<sup>5</sup> 3-1-55.

dealing the death blow to a principle that only a few months ago was hailed on all sides as a great step forward in bringing tax accounting into line with good accounting." So far as the effect on the revenue is concerned, Jack suggested that the reserve for estimated expenses set up in 1954, the transitional year, be stretched out for ten years if necessary. So far as the scope of the provision is concerned and the prevention of excesses and abuses, Jack recommended that the law be amended making "it crystal clear that the Secretary or his delegate has jurisdiction over items as well as amounts" that may be deducted. It certainly should be possible to adjust the provision "without scuttling the fine, necessary purposes served by the provision."

We urge our members to obtain a copy of Jack Seidman's statement. They will read a fair, able and vigorous statement of the accountant's position in this controversy.

#### Sales Tax—Locker Rentals

The Appellate Division had held<sup>6</sup> that the sales tax applied to receipts from coin-operated storage lockers where the patron has the right to the use of the locker for a 24-hour period and the right to lock and unlock the locker only once during the period. The Court of Appeals has just reversed this decision<sup>7</sup> on the ground that the sales tax applies only where there is a transfer of title or a transfer of actual, exclusive possession.

The court held that there is no constructive possession of the locker. The right to keep his baggage in the locker is at best a limited type of constructive possession. The patron has the right only to lock and unlock the locker once during a 24-hour period. If the patron had a real exclusive possession he

would have the right of opening and closing the door as many times as he wished during the 24-hour period. The transaction is no different from a hand-checking service, where an article is placed upon a rack and is not moved until called for.

The court distinguished this case from *Matter of United Artists Corp. v. Taylor*,<sup>8</sup> where a distributor transferred to an exhibitor positive and negative prints of photoplays with a license to use or exhibit them for a specified period. It also distinguished the case of *Buckley Funeral Home, Inc. v. City*,<sup>9</sup> where the sales tax was imposed upon rentals of automobiles by a funeral director. In both cases actual physical, exclusive possession of tangible personal property was transferred and remained under complete control of the licensee for a specified period of time.

#### Changing from Cash to Accrual Basis

A taxpayer may report his income generally on a cash or accrual basis. This is subject to the provision in the law that the method used must clearly reflect income. Where inventories are a factor in the determination of income only the accrual basis will best reflect income. Many taxpayers have been reporting income on a cash basis even though inventories are a factor in determining income.

Under the 1939 Code, the Commissioner could compel a taxpayer to change his method of accounting. In doing so the Commissioner usually made adjustments in the transitional year for accounts receivable and accounts payable as of the beginning of the year, throwing the former into income and allowing a deduction for the latter. He also made an adjustment for an initial inventory, for the reason that

<sup>6</sup> *American Locker Co., Inc. v. City of New York*, 283 A. D. 924.

<sup>7</sup> New York Court of Appeals, No. 288, March 3, 1955.

<sup>8</sup> 273 N. Y. 334.

<sup>9</sup> 199 Misc. 195; aff'd 277 App. Div. 1096.

the items included in such an inventory had already been deducted from income by the taxpayer when such items had been purchased and would result in a second deduction when an item was disposed of by sale. A number of court decisions had denied the Commissioner the right to make the necessary adjustments if the change to the accrual basis was involuntary. Where the taxpayer voluntarily requested permission to change his method of accounting the adjustments were required to be made. For that reason taxpayers continued reporting on an improper basis even though they would have preferred to change to a proper accrual basis.

The 1954 Code eased the burden of effecting a change. The law (Section 451) does provide that such adjustments must be taken into account in the year of the change as are necessary, because of the change, to prevent the duplication or omission of items. But "there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply." The significance of the latter provision lies in the fact that an initial inventory as of January 1, 1954, for example, could be set up and treated as a proper 1954 item. Accounts receivable as of January 1, 1954, may be set up without being accrued as income and accounts payable set up without a correlative deduction.

A change to the accrual basis in later years may still bunch adjustments after January 1, 1954, in one year. If such adjustments are substantial, the 1954 Code provides for a limitation of the resulting tax (Section 481(b)). If the method of accounting from which the change is made (cash basis) was used for two taxable years preceding the year of change, and the increase in taxable income for the year of change exceeds \$3,000.00, then such increase is spread over three years, the year of change and the two preceding years. If the taxpayer can establish his taxable income under the accrual basis for

one or more taxable years consecutively preceding the year of change, the tax for the year of change may not exceed the tax resulting from a proper allocation of a portion of the adjustments with the balance of the adjustments allocated to the year of change.

Several problems confront taxpayers who would wish to take advantage of the new provisions. The first is that a change in method of accounting (Section 446(e)) requires the consent of the Commissioner. Regulations under the 1939 Code provide that a request for such a change must be made within the first ninety days of the year to which the change is to apply. For the calendar year 1954, such a request should therefore have been made by March 31, 1954 (before the new Code was adopted). New regulations have not yet been issued. It is now too late to change to the accrual basis for 1954, and for 1955 the last day for securing consent was March 31, 1955. If a request to change were properly made in 1956, there would be a bunching of adjustments in 1956 affecting the years 1955 and 1956.

Another problem is the right of the Commissioner to compel a change to a proper method of accounting for any open year, including years prior to 1954, if he is made aware that this problem exists as to such years. Such a change for an earlier year would be involuntary, in our opinion, and the Commissioner would be bound by court decisions applicable under the 1939 Code.

What effect do these provisions have on the New York State Income Tax Law? Section 358 of the State Income Tax Law was amended by the present legislature and the following provision added:

"If the taxpayer's method of accounting is voluntarily or involuntarily changed, except where such change is to the installment method of accounting, adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or

omitted in computing net income or net capital gain subject to tax under this article, shall be taken into account. Any additional tax resulting from such adjustments shall not be greater than if such adjustments were ratably allocated and included for the taxable year of the change and the preceding taxable years, not in excess of two, during which the taxpayer used the method of accounting from which the change is made."

This provision is applicable to returns for any year commencing on or after January 1, 1954.

Article 13 of the regulations provides that a taxpayer may change his method of accounting with the consent of the Tax Commission. Such consent is usually granted if a similar consent has been given by the Commissioner of Internal Revenue.

Application for permission to change the basis of the return must be made at least thirty days before the close of the taxable year. It must be accompanied by a statement specifying the classes of items treated differently under the two systems and all amounts which would be duplicated or entirely omitted as a result of the proposed change. The taxpayer must also file a copy of the consent of the Commissioner of Internal Revenue to change the basis for federal tax purposes.

#### French Corporation and Individual Tax Law

The Controller's Institute has made digests of foreign corporation tax laws, individual tax laws, and employee benefit laws in existence in various foreign countries. The digest on French tax laws has already been released. Others will be released within the next several months. Members who are interested may obtain the releases from Norman Rothian, Controller's Institute, 1 East 42nd Street, New York, N. Y.

Under the individual income tax law a proportional tax (*Taxe Proportionnelle*) is levied on income of all types except wages and salaries paid by an

employer residing in France. Up to 1949, even wages and salaries were subject to the proportional tax, but employees were exempt from the tax at that time in lieu of an increase in salaries. Employers are liable to a payroll tax of 5% on wages and salaries.

Royalties paid to a foreign firm are subject to withholding at the source by the French licensee, unless a treaty provides otherwise to avoid double taxation. That is the case with royalties paid to a United States licensor.

The income tax on an unincorporated business or on professional services is based either upon an estimate of income made by the administration, or on real net profits or net income (including capital gains). If the basis of the tax is real net profits or income a deduction is allowed for losses of five preceding years. The proportional tax is not allowed as a deductible expense of the business. The basic normal rate is 18%, but the rate varies for different types of income.

The law makes no provision for a basic exemption if the total tax due by one person does not exceed 10,800 francs (\$30.92). In the case of professional services, the tax rate is only 9% on income between 200,000 and 350,000 francs, and 18% on income over 350,000 francs.

Capital gains of a commercial or industrial enterprise, which has been in existence over five years, are taxed at the rate of 6%.

While there is no provision for any exemption for a dependent wife, the tax is reduced by 15% for one child, 30% for two children and 45% for three children. However the exemption for each of the first two children may not exceed 5,000 francs, each, and 15,000 francs for each additional child. The taxpayer files an annual return, but the tax is assessed by the French fiscal administration.

Wages and salaries received from abroad are subject to tax at the 18%

(Continued on page 311)



# Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

## Reliance Upon Other Auditors: The Red Bank Oil Company Case

In a public accountant's practice it is not unusual for him to report on financial statements where part of the examination has been made by other public accountants. The accounts of an out-of-town branch, division or subsidiary may be examined by auditors located in or near the branch, division or subsidiary. Sometimes the out-of-town auditor is engaged by the principal accountant, who reviews the work of the other accountant, and pays his fee. In other cases the client engages the out-of-town accountant, whose report is made available to the principal accountant as a basis for reporting upon the over-all or consolidated financial statements. The variations in these arrangements are almost endless.

The SEC has said very little in its published decisions about an accountant reporting on financial statements where part of the examination is made by another accountant. The Commission, however, in January, 1946, issued a decision *In the Matter of the Red Bank Oil Company\**, which involved a number of accounting questions including reliance upon other auditors. We do not believe the case has been discussed in these columns.

The principal accountant in the Red Bank Oil case was a firm in Dallas, Texas. This accountant did not audit the Houston unit of a consolidated subsidiary. The Houston unit was audited by another firm of accountants located in that city. The principal accountant incorporated in his work papers the audit report for that unit

prepared by the Houston auditors. The Houston unit accounted for 70% of consolidated sales and 45% of consolidated assets. The Dallas auditors did not disclose in their certificate the fact that they relied on other accountants. The SEC said that it doubted the propriety of the principal accountant undertaking to express his opinion with respect to financial statements when, as to so large a percentage of the revenues and assets, his opinion is founded "merely on the reports of other accountants not subject to his supervision, control or direction."

According to the SEC, it appeared from the testimony that the principal accountant was not familiar with the Houston unit's accounts and that he was satisfied merely to incorporate them bodily in his working papers and over-all statements without further study. It appeared that he did not make any effort to determine whether the Federal profits were subject to renegotiation but accepted the Houston auditor's footnote to the effect that no provision had been made for renegotiation. The Dallas auditors did not know what inventory procedures were followed by the Houston auditors—did not, in fact, even know the basis used in determining costs. The SEC observed:

We think it wholly clear that where an accountant undertakes to express his opinion in part in reliance on reports of other accountants, it is essential that he have far more knowledge of the underlying facts and of the accounting principles followed than was exhibited here. Lacking such knowledge, it is impossible for him to express an informed judgment as to whether the figures reported to him by other accountants have been properly included in the consolidated statements . . . We also believe that the principal account-

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\*21 SEC 695.

ant is not in a position to express an informed opinion as to the financial statements where he excluded from his reviews so large a part of the revenues and assets.

Does the SEC's decision indicate that when the over-all examination has been made by more than one firm of accountants, the principal accountant must state in his report the extent to which parts of the examination have been made by other firms? We think not. (For the purpose of this article we shall reserve comment as to the much broader question raised by the decision, that is, the extent to which the principal accountant should be familiar with (1) the statements certified by the other accountant, and (2) the nature of the latter's examination.)

In 1950 (which is about four years after the *Red Bank Oil* case) the SEC revised its basic accounting regulation, Regulation S-X, and inserted a new provision in Article 2 dealing with certification of financial statements by more than one accountant. Rule 2.05 provides as follows:

If, with respect to the certification of the financial statements of any person, the principal accountant relies upon an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificate of such other accountant shall be filed . . . ; however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him.

Rule 2.05 (quoted above) is the latest expression by the SEC on an examination made by more than one accountant. To the extent that it conflicts with the decision in the *Red Bank Oil* case, we think Regulation S-X is controlling. As we see it, the Commission's present position appears to be this: the accountant is not required to make reference in his certificate to the fact that part of the ex-

amination has been made by another firm or firms. If, however, the principal accountant reports that others have participated in the over-all examination, then, in an SEC filing, there are these alternatives: (1) the certificates of the other participating auditors must be furnished, and these certificates are subject to the same rules as are applicable to the certificate of the principal accountant; or (2) the principal accountant must assume responsibility for the work done by the other auditors in the same manner as though the work had been done by him.

We think the principal accountant does not have to disclose in his report the extent of participation by others in the over-all examination when the principal accountant engages the other auditors, plans the work to be done by them, reviews their work, receives the report directly from the other accountants, and pays the fee for the examination made by the other accountants. On the other hand, when the out-of-town accountant is engaged by the client, the principal accountant has no hand in planning the work, the other accountant reports directly to the client, and his work is not reviewed by the principal accountant, we believe the principal accountant should disclose in his certificate the fact that he relied upon an examination made by another accountant. In the latter situation the principal accountant customarily does not assume responsibility for the work done by the other accountant. In these circumstances the report of the principal accountant will read somewhat as follows:

We have examined the consolidated balance sheet of Company A and its subsidiaries as of (date) and the related statements of income and surplus for the fiscal year then ended. We were furnished with financial statements of Canadian Subsidiary B as of (date) and for the fiscal year then ended, together with the report thereon dated \_\_\_\_\_ of Messrs. X, Y and Z, chartered accountants. Our examination was made in accordance with generally accepted auditing standards, and

accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, based upon our examination and upon the afore-mentioned report of chartered accountants, the accompanying financial statements present fairly, etc.

A certificate along these lines, filed with SEC, would have to be accompanied by a report of the named chartered accountants, since the principal accountant does not assume responsibility for their examination.

We have referred above to two types of arrangements between the principal accountant and the other accountants: in the first the principal accountant in effect employs the other accountant; in the second, the principal accountant is merely furnished with a copy of the report of the other accountants. In practice all kinds of variations in arrangements are possible. What the principal accountant should do in a particular case and what he should say in his report would depend on the circumstances in each case.

From the viewpoint of protecting the certifying accountant, a case\* decided in 1935 by the Court of Appeals of Ohio demonstrated the desirability of disclosing the fact of reliance on other auditors. The defendant in that case had signed a certificate reading as follows:

We hereby certify that we have examined the books of account and record of International Match Corporation and its American subsidiary company at December 31, 1929, and have received statements from abroad with respect to the foreign constituent companies as of the same date. Based upon our examination and information submitted to us, it is our opinion that the annexed consolidated balance sheet sets forth the financial condition of the combined companies at the date stated, and that the related consolidated income and surplus account is correct.

The defendants had certified that the net income for the years 1929 and 1930 had been in excess of \$20,000,000. A

subsequent audit by other accountants revealed annual net earnings for the years involved to be approximately \$8,000,000. The plaintiff brought an action for damages for fraudulent misrepresentations on the part of the accountants. The plaintiff alleged that the certificates made by the defendant accountants were fraudulent, in that the defendants purported to have knowledge of the facts when in truth the defendants had no such knowledge, and that the fraud was not discovered until after the suicide and death of Ivar Krueger, which occurred in Paris in 1932.

The Court ruled for the defendants saying, in part, as follows:

If certified public accountants examine the books and records of a corporation and certify that the balance sheet reflects the true condition of the books and records examined, and there is a substantial variation between the balance sheet and such books and records, an action would no doubt lie against the accountants, where the certification was made knowingly, or where there was a pretense of knowledge when in fact they had no knowledge.

In the instant case, however, the certificate made by [the certifying accountants] clearly states that it is based both upon an examination of records and upon statements received from abroad with respect to the foreign constituent companies. The language used in the certificates gives rise to the indisputable inference that the accountants had not examined the books and records of the foreign constituent companies.

The records do not establish fraud or any false or fraudulent statements in relation to the examination actually made of the books and records in this country. We do not think that the defendants can be charged with fraud under these certificates by the very language used therein, when they in fact disclose that some of the information and statements came from abroad. It is obvious that the accountants in this case could not know whether or not the information from abroad was accurate or inaccurate, and, inasmuch as they disclose that the certificates were based partly on information so received, there was no pretense of knowledge as to the information received which would make defendants liable.

\* *Beardsley v. Ernst*, 47 Ohio App. 241.

## Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

### Experiences of the Personal Income Tax Period

Discussions with a number of accountants as to experiences with the preparation of personal income tax returns under the new Code brought out some interesting reactions. Here are some of the highlights:

1. The returns required up to 33 $\frac{1}{3}$ % more time to prepare, mainly because of the new relief provisions.

2. Getting information from taxpayers as to applicable relief provisions was largely responsible, but the review of the data and the computations were also major problems.

3. Fees for the preparation of returns are being increased. Where no charge has been made to individuals connected with client companies, some accountants will revise this policy.

### Responsibilities as to Personal Income Tax Returns

Each tax season rouses thinking as to the accountant's duty with respect

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to income tax data submitted to him for his use in the preparation of personal income tax returns. Is it sufficient merely to transpose the data, or must he make a detailed audit of it, or does his duty fall somewhere between these two extremes. No generalization is possible except, perhaps, this—that the accountant must recognize that his reputation is at stake in any event, and that the taxpayer client should know, in advance, the condition on which his data is accepted. Questions such as these arise constantly: Should a list of dividend income items be audited to insure that the amounts are correct? Should interest and dividend income be checked with specialized services as to their taxability? Should security holdings be checked for unrecorded non-cash distributions which may be taxable? Etc., etc. The viewpoints of practitioners on this subject are solicited and more will be said on it at a later date.

### Internal Revenue Service Publications

Much client goodwill is generated by the act of sending them pamphlets of interest, or advising them of the availability of such material. The following recent pamphlets, obtainable from the Internal Revenue Service, may be found useful:

Income Tax Guide for U. S. Citizens Abroad

Withholding Guide

Domestic (Servant) Employers  
Social Security Guide Book

# Payroll Tax Notes

Conducted by SAMUEL S. RESS

## Unemployment Insurance — Subsidiary Contributions — Extension of Coverage

The Society's Committee on State Taxation held its Spring meeting on March 23rd, 1955, at which some 200 members were present. While the general theme of the meeting was "Tax Problems Arising from Activities in More Than One State", the new Executive Director of New York State's Division of Employment, Richard C. Brockway, participated in a discussion with the writer on "Unemployment Insurance Problems Facing the Practitioner." During the course of the discussion, we learned that a number of amendments to the New York State Unemployment Insurance Law were to be enacted.

In reply to a question regarding the subsidiary contribution requirement in the law, of an additional  $\frac{1}{2}$  of 1 per cent, which we escaped by a narrow margin last year through an amendment which changed the closing date from June 30th to July 1st of the year, we were informed that further changes were contemplated this year. We have just learned that the Legislature passed a bill which is now awaiting the Governor's signature. It would change the schedule of subsidiary contributions by employers to a rate varying from 0.1

per cent to 1.0 per cent, instead of the present two fixed rates of 0.5 per cent or 1.0 per cent.

## Employers of Less Than Four Employees

Another bill has been passed, which extends coverage to employers of 2 or more employees, instead of 4 or more on each of 15 days in a calendar year, commencing January 1, 1957. Employers of 3 or more will become covered on January 1, 1956. Domestic workers are considered separately, and coverage is required if 4 or more are employed on any day.

## Unemployment Insurance Experience Rating Qualifying Period

When it was pointed out by the writer that the recently-amended Federal law permits the cutting of the present three-year merit rating qualifying period to one year, and that the Commonwealth of Virginia was the first state to reduce the qualifying period, it was indicated that some similar measure might be forthcoming in New York. We now learn that the Legislature has passed a measure to reduce from 14 to 4 the number of calendar quarters for which contributions must be made by an employer before qualifying for experience rating.

## Maximum Benefit Rate Raised from \$30 to \$36

Another measure passed by the Legislature, and certain to be signed by the Governor raises the maximum unemployment insurance benefit rate from the present \$30 to a new ceiling of \$36. This increase will adversely affect those firms who are not attentive to unemployment insurance charges against their experience rating ac-

(Continued on page 311)

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committee on State Taxation and Chairman of the Sub-Committee on Unemployment Insurance.

# Official Decisions and Releases

## Joint Statement on Competitive Bidding for Audit Services to Governmental Agencies

by

The Committee on Governmental Accounting  
American Institute of Accountants

and

The General Committee on Accounting  
Municipal Finance Officers Association of the United States and Canada

Competitive bidding has long been associated with efficient administration of governmental organizations, for such procedures are the best-known guarantee of obtaining the highest quality of commodities at the lowest price possible. In fact, competitive bidding has been so universally recognized that nearly all governmental agencies are compelled by law to obtain materials and supplies and to undertake public works projects through competitive bidding procedures.

To be effective, however, competitive bidding procedures must be applied to commodities that can be measured by exact specifications and standards; for example, a request for bids for an order for automobile tires would specify the grade of rubber, the type of thread to be used in the cord, the number of plies, the thickness of the tread, and so forth. The tires obtained from the successful bidder would be tested to ascertain that they met the required specifications. Similarly, the request for bids on a construction job would specify the exact type and grade of material that was to be used throughout. During the progress of construction, inspectors would check the material against the specifications and would also determine whether such material was being installed in accordance with acceptable standards.

The legislative bodies or other representatives of many governmental agencies frequently call for competitive bids when they are arranging for an audit. They fail to recognize the fact that the services which they are seeking are professional services and not a commodity.

This confusion of principle on the part of many legislative bodies is confined only to the services of auditors. They would never think of advertising for bids in order to hire appraisers in condemnation actions, or a special attorney to represent them in court, or an architect to draw plans and supervise construction of a building, or any type of special consultant other than an auditor.

Auditing services, like many other professional services, are of such a nature that it is impractical for them to be covered by rigid specifications. An accounting firm performing an audit should have as much latitude as it may find necessary to be assured that the records are in order and that the system of accounts is functioning properly. In spite of the obvious objections, some governmental organizations have selected auditors on the basis of competitive bidding. That the results of such engagements have usually been acceptable is a high tribute to the integrity of the members of the profession.

Many public officials are opposed to competitive bidding in the selection of an auditor but are forced to accept this program because of legal requirements. In many of these cases a legal opinion would disclose that the requirement to call for bids does not apply to professional services. To call for bids, except when required by statute, suggests the possibility that a governmental organization is trying to meet mandatory requirements for an audit at the lowest possible cost and with complete disregard for the results produced or the purposes of such audit.

It is also possible that representatives of governmental organizations are reluctant to choose one of several acceptable auditing firms and resort to the practice of calling for competitive bids to avoid this responsibility. Such a procedure, however, opens the door to bids from firms or persons which might not be acceptable. The larger governmental units are likely to have several outstanding auditing firms available and these larger units might well make a joint appointment of several firms, with each firm handling some particular phase of the audit.

If you are contemplating having an audit of your governmental agency, select the most competent auditor in your community and familiarize yourself with Part 3 of the book, "Municipal Accounting and Auditing," published by the National Committee on Governmental Accounting, which deals with municipal audit procedures. It contains a



suggested basis of understanding between the governmental agency representative and the auditor and a suggested audit procedure to be followed.

Having arrived at a definite understanding with the auditor as to the scope of the

audit, both parties understand what ground is to be covered, approximately how long it will take if no unforeseen problems are encountered, and the auditor is then in a position, if required, to state a ceiling above which his per diem charges will not go except for possible unforeseen problems.

### Payroll Tax Notes

(Continued from page 309)

counts and will result in higher unemployment insurance tax costs unless proper controls are instituted.

#### \$10 Request Report Penalties

While no legislation eliminating the \$10 penalty for failure to report on the LO 12 or 12.1 Information Return has been enacted, some relief under certain circumstances on the administrative level is contemplated.

#### Sick Pay Withholding—New Regulations

Employers may, but are not required, to exclude some sickness and personal injury payments from withholding under wage continuation plans during 1955. The sickness and disability payments which may be excluded are those which the employee is entitled to exclude, subject to the \$100 weekly limitation, from his gross in-

come under section 105 (d) of the 1954 Internal Revenue Code.

The Commissioner plans to take away the employer's option with respect to withholding of sickness and disability payments under wage continuation plans after 1955, and to require the exclusion under certain circumstances. First, withholding will be required with respect to payments made for the first seven days of absence, whether due to sickness or disability. Payments for a sustained absence after the first seven days will be excluded from withholding up to the \$100 weekly rate. The employee will be given an additional \$100 exemption from withholding over and above his regular personal and dependents exemption, providing he files with the employer a written statement certifying reasons for absence and whether or not he was hospitalized during the period of his illness.

### New York State Tax Forum

(Continued from page 304)

rate. American employees working in France for an American firm which has no permanent establishment in France are subject to the tax on their wages and salaries unless they are in France on a "temporary mission" for less than one year. An employee receiving his salary from abroad computes the tax himself and pays it over to the tax authorities. Since 1953, such employee may consider himself his own employer and in lieu of the 18% tax pay the 5% payroll tax. He must

notify the French taxing authorities of this election and attach to the annual tax return a certificate from the employer abroad showing the total salary paid during the past year.

Pensions are subject to the 18% proportional tax, except those paid by the French Government, local or municipal authorities, or by government controlled organizations. The exempt pensions are however subject to a payroll tax of 3% paid by the authority paying the pension.



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## A red-nosed Fokker slowly spun to earth



At 4:35 P.M., on October 30, 1918, a Spad biplane, marked with the symbol of the "Hat-in-the-Ring" Squadron, had come down through the quiet skies over Grand Pré. Seconds later, a twenty-round burst from its guns smashed full into the center of a flying Fokker and sent the German plane swirling earthward like an autumn leaf.

The squadron C.O., Captain Eddie Rickenbacker, had downed his last enemy plane in the war, setting a record for aerial combat never equaled: 26 victories in 7 months made him the American ace of aces.

A year earlier, his mother had written, "slowly and close to the ground"; but it was his advice that Eddie Rickenbacker—like many of his fellow Americans—has never been able to take. His calculating courage, ingenuity and drive are typical of our greatest assets.

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